S. Hrg. 98-990

FAIRNESS AND THE REAGAN TAX CUTS

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

SECOND SESSION

JUNE 12, 1984

Printed for use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
38-037 O WASHINGTON : 1984

J841-40

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Congress]

SENATE

ROGER W. JEPSEN, Iowa, *Chairman*
WILLIAM V. ROTH, JR., Delaware
JAMES ABDNOR, South Dakota
STEVEN D. SYMMS, Idaho
MACK MATTINGLY, Georgia
ALFONSE M. D'AMATO, New York
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

HOUSE OF REPRESENTATIVES

LEE H. HAMILTON, Indiana, *Vice Chairman*
GILLIS W. LONG, Louisiana
PARREN J. MITCHELL, Maryland
AUGUSTUS F. HAWKINS, California
DAVID R. OBEY, Wisconsin
JAMES H. SCHEUER, New York
CHALMERS P. WYLIE, Ohio
MARJORIE S. HOLT, Maryland
DANIEL E. LUNGREN, California
OLYMPIA J. SNOWE, Maine

DAN C. ROBERTS, *Executive Director*
JAMES K. GALBRAITH, *Deputy Director*

CONTENTS

WITNESSES AND STATEMENTS

Tuesday, June 12, 1984

Page

Jepsen, Hon. Roger W., chairman of the Joint Economic Committee: Opening statement 1

Roth, Hon. William V., member of the Joint Economic Committee: Opening statement 2

Roberts, Paul Craig, Center for Strategic and International Studies 3

Gwartney, James, professor, Florida State University 44

Rahn, Richard, vice president and chief economist, U.S. Chamber of Commerce 78

Pratt, Lawrence, economic journalist, American Institute for Economic Research 91

Vedder, Richard K., professor, Ohio University, accompanied by Lowell Gallaway, professor, Ohio University 104

SUBMISSIONS FOR THE RECORD

Tuesday, June 12, 1984

Gwartney, James: Prepared statement 47

Pratt, Lawrence: Prepared statement, together with attachments 93

Rahn, Richard: Prepared statement 80

Roberts, Paul Craig:

- Prepared statement 6
- Articles entitled:
  - "What Ronald Reagan Doesn't Know About His Own Achievements" 36
  - "Tax Cut Debate Shows Reagan Staff Conflicts" 40

Vedder, Richard K., and Lowell Gallaway: Joint prepared statement 108

FAIRNESS AND THE REAGAN TAX CUTS

TUESDAY, JUNE 12, 1984

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SR-428A, Russell Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Roth, and Symms.

Also present: Dan C. Roberts, executive director; Charles H. Bradford, assistant director; and William R. Buechner and Christopher J. Frenze, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator **Jepsen**. It gives me great pleasure to welcome our distinguished witnesses testifying before us today on "Fairness and the Reagan Tax Cuts." The misinformation about this issue, spread for over 3 years, has established a need to set the record straight.

The Economic Recovery Tax Act of 1981 was designed to restore incentives to work, to save, and to invest. Once implemented, the tax reductions would help lay the foundation for a sustained economic expansion without high inflation. Unfortunately, the schedule of tax cuts was delayed for most taxpayers during congressional consideration of this tax legislation. However, part of an alternative measure, dropping the top marginal rate from 70 percent to 50 percent effective 1982, was incorporated in ERTA. While watered down somewhat by Congress, ERTA did lift some of the tax burden then stifling the American economy.

Though sidetracked for a while by an unduly harsh monetary policy, the current economic expansion has been remarkably robust as well as noninflationary. The main objective of the administration's fiscal policy—economic recovery—has been achieved. The stagflation of the late 1970's and early 1980's is now only a bad memory. Nonetheless, partisan attacks on the 1981 tax legislation continue. Opponents of the legislation make the argument that even when fully effective, the Reagan tax cuts primarily benefit the rich. These critics allege that under ERTA, an enormous amount of tax revenues is being given away to the wealthiest taxpayers, thereby shifting the tax burden onto the middle- and lower-income taxpayers. This morning we will carefully examine this controversy over the impact of the marginal tax rate reductions on the tax payments of various income groups.

There is nothing new about the idea that marginal tax rates can be high enough to shrink the tax base and depress tax revenues. In 1924, Treasury Secretary Andrew Mellon observed:

> The history of taxation shows that taxes which are inherently excessive are not paid. The high rates inevitably put pressure on the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find some other lawful methods of avoiding the realization of taxable income. The result is that the sources of taxation are drying up, and capital is being diverted into channels which yield neither revenue to the government nor profit to the people.

The historical record suggests the validity of Mellon's views. After the Mellon—1921, 1924, and 1926—and Kennedy—1964–65—tax cuts, the amount and share of taxes paid by the rich increased. Today we will examine current revenue trends to see how well Mellon's theory is holding up.

In closing, I would like to recognize the leadership demonstrated by Senator Roth in reducing the tax burden on the American people. The Roth-Kemp bill laid the foundation for a robust and sustained economic expansion and job creation. Just in the last year, 5.5 million new jobs have been created and, as well all know, today we have more people employed in this country than we have ever had in our history.

Welcome, Senator Roth. You were a prophet and a pathfinder and you blazed the way. Do you have any remarks?

OPENING STATEMENT OF SENATOR ROTH

Senator ROTH. Well, thank you, Mr. Chairman. Let me, if I may, just take a couple of minutes.

First of all, I'd like to express my appreciation to you for holding these hearings today and bringing such a distinguished panel to discuss what I consider a very unfair and biased attack on the whole approach of lowering marginal tax votes.

I think behind all these attacks lies one very basic concept and that is, bigger taxes are better. I really think the reason you see these very tough and inaccurate attacks coming from time to time is that those who believe in big government think you have to have high taxes, when in fact I think you probably get more revenue if you have a growing economy.

Now I would just like to express some current concerns that I've had over the last 3 or 4 years since we did adopt the Kemp-Roth or Roth-Kemp tax cut, whatever you may want to call it. Really, it's Reaganomics: He's the one that put it through. But I am concerned that since then we have had a number of tax increases and that basically, instead of being concerned in committee with the question of what kind of an impact do these taxes have on the economy, we have only had one criterion, and that criterion has been how much revenue does it raise?

We have had four or five tax increases since the big one at the beginning, and I don't know how the private businessman in the private sector can plan. I can tell you right now they are already talking about another tax proposal next year. If we have a tax reform next year, it's important that the primary criteria be how do we continue this recovery, and how do we maintain long-term growth.

I am going to have some proposals in the near future, Mr. Chairman. I am a strong believer that we have got to continue the path of lowering taxes. The flat tax has a lot of merit. I don't think we will ever arrive at that. But I also believe that we've got to build some real incentives to savings and that has to be a key part to any reform.

But I do want to go back to expressing my appreciation to you for having these hearings. I'd just like to make one final comment if I might.

Talking about the fairness issue, it seems to me that nothing is more unfair than a lack of economic growth because when the economy is stagnant it's the people on the lower end of the economic scale that most suffer. They are the ones that lose the jobs. They are the ones that are paid less. So that any economic policy that increases economic growth creates opportunity. It's a strong recovery that gives jobs and that's the point you made in your opening statement, Mr. Chairman, where you said that several million new jobs have been created.

But I was interested that in September 1983 in the National Tax Journal, there was an article by Alan Sinai, who has been in the past quite hostile to so-called supply-side policy, yet he points out that the Roth-Kemp tax cuts were very influential in stimulating growth and he claims that real GNP in 1981 would have been $5 billion less absent the Roth-Kemp tax cuts and ACRS, and $24.6 billion less in 1982. According to his research, personal savings would have been $12.7 billion less in 1981, $33 billion less in 1982, $86 billion less in 1983, and $86.1 billion less in 1984.

According to this research, total investment would be less by $56.1 billion over the period 1981–85 if the 1981 tax bill had not passed.

As I say, I think one of the interesting things is that here's a man who was not an early supporter of our tax proposals, but he says now that it has played a significant role.

Thank you, Mr. Chairman.

Senator JEPSEN. I thank you, Senator.

Now we will go to the panel. We have Mr. Paul Craig Roberts, Center for Strategic and International Studies; Richard Rahn, U.S. Chamber of Commerce; James Gwartney, professor from Florida State; Richard K. Vedder, professor from Ohio University; and Lawrence Pratt, American Institute for Economic Research.

As you're seated, I think we should just follow from my right to my left, and that calls first for the testimony of Paul Craig Roberts. The Chair would advise the distinguished panel members that your prepared statements will be entered into the record. You may proceed in any manner you so desire.

STATEMENT OF PAUL CRAIG ROBERTS, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Mr. ROBERTS. Mr. Chairman, I have a very brief opening statement. I would like to congratulate you for holding this hearing. Economic growth is the only hope we have of meeting our national defense needs, maintaining the social security system, and absorbing the millions of immigrants that enter our country. Yet the Reagan-Kemp-Roth tax cut, which improved the longrun growth potential of our economy, has been viciously attacked by people who may be misinformed or who may be lying for political reasons.

The charge has been made that the Reagan-Kemp-Roth tax cuts are "tax cuts for the rich," and a campaign has been launched to portray the President as "Reagan Hood" who robs the poor to give to the rich. All of the factual evidence contradicts these charges, which have figured predominantly in the Washington Post.

Internal Revenue Service statistics clearly show that following the reduction in the top marginal tax rate from 70 to 50 percent, upper income taxpayers are paying more in income taxes, both absolutely and as a percentage of total income tax collections. Lower income taxpayers are now paying less, both absolutely and as a percentage. The unambiguous result was to shift the burden of the income tax toward higher income taxpayers, not to create a "windfall for the rich." This result was correctly predicted by supplyside economists, and it repeats the pattern of the Kennedy and Mellon tax cuts.

Faced with the evidence, opponents of the tax cuts tried to cover it up. They argued that the tax burden on lower income people had fallen because they lost their jobs and had no income to report as a result of Reagan's economic policies. And they attributed the shift in the tax burden toward upper income people to rising capital gains income due to the bull market.

These specious arguments are an indication that some people prefer to discredit the tax cuts than to look carefully at the evidence. As the IRS figures show, less income was reported in lower brackets in 1982—as compared to 1981—because of movement from lower brackets to higher ones and because Individual Retirement Accounts [IRA's] expanded fivefold.

Capital gains income is too small a share of total income to account for the increase in taxes paid by upper income people. Normally, recession impacts business income worse than personal income. Since business income is a larger share of upper bracket income, the drop in the tax burden on lower income people and the rise in tax burden on upper income people cannot be attributed to the affects of the recession.

Mr. Chairman, the current economic recovery has some unusual features that can only be attributed to the success of the supplyside tax cuts. During the first year of recovery measured from the fourth quarter of 1982 through the fourth quarter of 1983, the growth in consumption lagged the growth in the real GNP. Clearly, it was not a consumption-led Keynesian-style recovery.

In contrast, real gross private domestic investment grew much faster than GNP. Nonresidential fixed investment contributed about three times as much to the growth of real GNP than is typical of the first year of recovery. This is an indication that the economy's ability to grow is increasing, which should help to maintain productivity and to ward off the capacity bottlenecks that lead to the resumption of price pressures. The swift decline in the unemployment rate from the high of a bad recession is record-level performance and exceeds all predictions.

The mistaken economic policies of the 1970's, which pumped up demand while restraining the response of supply, brought persistent inflation to the U.S. economy and resulted in stagflation. The initial supplyside reforms of the Reagan administration are a first step in regaining economic health. We are not likely to take further necessary steps if these positive policies are denigrated and their results misrepresented. The evidence presented at this hearing today will help to keep the record honest.

Mr. Chairman, this completes my oral statement. I am submitting for the hearing record a longer prepared statement entitled "Taxation, Relative Prices, and Capital Formation," which will later be published by the Pacific Institute for Public Policy Research in a book on taxation and capital markets. I request permission to make revisions in my statement, keeping, of course, to the committee's regular publication schedule.

Mr. Chairman, I also would like to submit for the record a copy of a recent article by George Gilder and a recent article by Warren Brookes.

Senator **Jepsen**. They will be entered into the record. I thank you.

[The prepared statement of Mr. Roberts, together with the articles referred to, follows:]

PREPARED STATEMENT OF PAUL CRAIG ROBERTS*

Taxation, Relative Prices, and Capital Formation

While the concept of relative prices is a foundation of microeconomic theory, it has been ignored by Keynesian macroeconomic policy.1/ As a result, capital formation suffered. Capital formation requires that real resources be saved from current consumption and employed in investment. In the case of human capital, time is a resource that must be diverted from leisure and invested in improving skills. These decisions, which determine the rate of capital formation, are influenced by relative prices.

To begin with, consider the relative price that determines the allocation of income between consumption and saving. The cost to the individual of allocating a unit of income to current consumption is the future income stream given up by not saving and investing that unit of income. The value of that income stream is determined by marginal tax rates. The higher the tax rate, the less the value of the income stream. High tax rates make consumption cheap in terms of foregone income, so saving declines, leading to less investment.

Consider a husband facing a 95 percent marginal tax rate on investment income. He has, for example, the choice of investing $20,000 at 10 percent or buying his wife a diamond necklace. On a pre-tax basis the cost of giving his wife the necklace is to forego an income stream of $2,000 a year--not an insignificant sum. Aftertax, however, the value of the additional income stream is only $100 a year (the 5 percent of $2,000 remaining after taxes). His tax bracket reduced the cost of the necklace to one-twentieth of its pre-tax cost.

---

* I would like to thank Peter Barlerin, my research assistant, for his help in preparing this article.

While this may seem like an unrealistically high tax rate, until just a few years ago the top marginal income tax rate on investment income in Great Britain was 98 percent. This explains why there are so many Rolls Royces and other fine automobiles on the streets of London. The Rolls Royces have been mistaken as signs that the rich are prospering, when in fact they are warning signals that the tax rate on investment income is excessive. The effect was to reduce the price of current consumption in terms of foregone income almost to zero. As inflation and real economic growth pushed taxpayers into higher tax brackets, consumption became progressively cheaper, and saving more expensive, for large numbers of people.

The other important relative price governs people's decisions about how they allocate their time between work and leisure or between leisure and improving their human capital by upgrading skills. The cost to the individual of allocating an additional hour to leisure is the current earnings sacrificed by not working (for example, overtime on Saturdays) or the future income given up by not improving human capital. The value of the foregone income is determined by the rate at which additional income is taxed. The higher the marginal tax rates, the cheaper the price of leisure. Work attitudes deteriorate, absenteeism rates go up, people are unwilling to accept overtime work and devote less effort to improving work skills. In other words, labor supply declines. With less labor to work with, the marginal productivity of capital falls. This reduces capital formation, and economic growth stalls.

High marginal tax rates shrink the tax base because they discourage people from earning additional taxable income. Professionals who reach the 50 percent tax bracket early in the tax year are faced with working the additional months of the year for only half of their pretax earnings. Such a low reward for effort encourages professionals to share practices in order to reduce their working hours and enjoy longer vacations. A tax rate reduction would raise the relative price of leisure to professionals and would give them the incentive to earn more taxable income and increase the supply of professional services.

The effect of tax rates on the decision to earn additional taxable income is not limited to professionals in the top bracket. Carpenters and bricklayers prefer some of their earnings to be paid "off the books" so they can avoid declaring the portion of their income which falls into their highest marginal tax bracket.

An alternative to taxable income is to use labor services to produce non-taxable household services. Consider a carpenter earning $100 a day whose take-home pay is $75. Suppose that his house needs painting and that he can hire a painter for $80 a day. Since the carpenter's take-home pay is only $75, he saves $5 by painting his own house. In this case the tax base shrinks by $180--$100 that the carpenter chooses not to earn and $80 that he does not pay the painter. The higher the marginal tax rates, the more likely it is that people can increase their income by using their resources in non-market activities or in the underground economy.

The progressive income tax is perverse because it mismatches effort and reward. Each additional effort comes on top of existing effort, so the disutility to the individual of additional effort is high. But since the income from the additional effort goes on top of existing income, it is taxed at higher rates. As efforts rise, rewards fall. The tax system is not only perverse but self-defeating. By raising the price of activities that expand the tax base, progressive tax rates reduce the tax base and frustrate the goal of raising revenues.

Tax Bias Against Saving

Capital formation is subject to additional burdens when saving is taxed twice--once when it is earned and again when it yields an income stream. If there is no deduction either for the initial saving or for the income stream generated by the saving, the portion of income saved is taxed at a higher effective rate than the portion of income used for current consumption.[2/] The income tax bias against saving is illustrated in the following example. In the absence of taxes, the individual who earns an additional $1,000 must decide whether he wants to consume it now or save it at, for example, a 10 percent interest rate. The cost of current consumption in terms of foregone income is $100 a year. Now assume that the same individual is in a 50 percent marginal income tax bracket, so that for every additional $1,000 he earns he is allowed to keep $500.

If the income stream from saving was not taxed, he would be faced with the same relative price: the cost of $500 in current consumption is a foregone income of $50 annually. But since the income from saving is also taxed, the cost of consumption in terms of foregone income drops by half to only $25 annually. For an individual in the 50 percent marginal income tax bracket, the inclusion of saving in the tax base cuts the relative price of current consumption in half.

The disincentives in the progressive tax system are aggravated by inflation, which pushes people into higher marginal income tax brackets even though their real pre-tax income does not change. Bracket creep served as an undebated and hence ideal tax increase from the standpoint of big spenders in the government, but its effects have been devastating to the economy. In 1965 a median income family of four faced a 17 percent marginal income tax rate on personal income. By 1981, the rate had jumped to 24 percent--a 41 percent increase in the tax rate on additions to the family's income. If social security taxes and state income taxes are included, the median income family today is in the 40 percent marginal income tax bracket or higher. A family with twice the median income saw its federal marginal tax rate nearly double, rising from 22 percent in 1965 to 43 percent in 1981. The steep increases in marginal tax rates hurt saving particularly, because income from saving and investment is added to wage and salary income and is automatically taxed at the taxpayer's top rate.

Tax law has interacted with inflation to erode saving in other ways as well. Inflation favors borrowers at the expense of lenders. A person who borrows $1,000 for one year at 10 percent pays back $1,100 next year. If the inflation rate is also 10 percent, the $1,100 paid back purchases no more merchandise than the $1,000 the year before, so the real, or inflation-adjusted, interest rate is zero. It would seem like a reasonable goal for tax policy to offset the unfair advantage inflation presents to borrowers, but in fact tax policy has often worked in the opposite direction to reinforce the advantage of the borrowers.

Borrowing cost are lowered by the interest deduction, which rises with the marginal tax rate. As the marginal tax rate increases, the price of saving increases while the price of borrowing falls. The interest deduction for the 50 percent marginal tax bracket, for example, cuts the aftertax interest rate in half. When combined with inflation, interest deductability frequently produces negative real aftertax interest rates--a form of reverse usury. The government has offered many carrots to borrowers, reserving the stick for savers. Government-imposed ceilings on interest rates, such as Regulation Q, forced a negative interest rate on savers when the inflation rate rose above the fixed interest rate. Many people found that the only way they could "save" at all was to go into debt. The many disincentives to save that have afflicted the economy, such as the double taxation of saving, bracket creep, interest deductability and interest rate ceilings, come on top of the bias against saving imposed by high marginal tax rates.

How Taxation Crowds Out Investment

As the price of saving increased rapidly relative to consumption and borrowing, it is not surprising that the personal saving rate averaged only 6.1 percent between 1976 and 1980--one of the worst five-year periods in the postwar era and substantially below the 7.8 percent average rate from 1966 to 1975. The decline in the saving rate reduced funds available to the capital markets by $130 billion during 1976-80--a sum equal to half of the cumulative budget deficits for the period.

Business saving and investment fared equally poorly. Depreciation laws did not permit business to write off capital investments rapidly enough to recover replacement costs for worn out plant and equipment. A large portion of business saving that should have gone towards the replacement of plant and equipment was instead taxed away by the government. In the non-financial corporate sector, the replacement values of inventories and fixed assets were understated by $262 billion during 1976-80--a sum equal to the cumulative budget deficits for the period. Note that the total preemption of private sector saving by the tax system was 50 percent greater than the preemption of private saving by the federal deficit.

Understating depreciation overstated corporate profits, which raised the effective corporate tax rate above the statutory rate. When book depreciation allowances are adjusted to a replacement cost basis, corporate profits were taxed at a higher rate than the statutory rate for more than a decade, averaging 56 percent in the 1970s and reaching 77 percent in 1974 (see table 1).

As in the case of individuals, the tax system encouraged businesses to accumulate debt instead of equity. Because payments to equity are made from taxable income but debt service costs are tax deductible, businesses joined individuals in becoming "debt junkies."

Table 1
Effective Corporate Tax Rates

1960	54.1%
1961	53.4
1962	47.0
1963	46.2
1964	43.3
1965	42.0
1966	43.3
1967	43.3
1968	49.3
1969	53.8
1970	58.4
1971	53.6
1972	50.4
1973	55.9
1974	76.8
1975	53.9
1976	53.6
1977	49.7
1978	50.9
1979	56.4
1980	58.6

Nonfinancial corporate profits tax libalibities as percent of corporate profits with inventory valuation adjustment and depreciation of fixed assets adjusted to replacement costs at double-declining balance over 75 percent of Bulletin F service lives.

When the term "crowding out" is used by conservative Republicans, it is intended to convey the image of private investment being pushed out of financial markets by Treasury borrowing forcing up interest rates. But government also crowds out by taxation. As noted above, during the Carter Administration, the tax system crowded out private saving by an amount substantially greater than the budget deficit.[3] From an investor's standpoint, interest rates are deductible, but tax rates are not. A 50 percent tax rate doubles the rate of return necessary for an investment to pay out. If an investor in the 50 percent marginal tax bracket requires a 10 percent return, he will only undertake new projects that yield, before tax, a 20 percent return or higher. All investment projects that fall between the 10 and 20 percent rate of return are effectively crowded out by taxation.

The adverse change in relative prices, which made current consumption and leisure cheaper in terms of foregone income, followed from a demand management policy that saw taxation as a tool to raise or lower the level of aggregate demand or spending in the economy. In this view marginal tax rates do not carry any significance. They can be as high as egalitarians and politicians demand as long as government spends the money. The effects of tax policy on the relative prices that influence capital formation were simply ignored.

The theory behind the Keynesian economic model is best reflected in the two alternative prescriptions for expansion--tax cuts or increases in government spending. Tax cuts are seen to have less impact or "bang for the buck" because people save a portion of their tax cuts while the government could be counted on to spend the full amount. Keynesians believe that demand creates its own supply and that if there is an adequate level of aggregate demand in the economy, supply moves to meet it. With a tax policy that concentrated on average tax rates and ignored the marginal rates, no notice was taken of the rising disincentive to produce. Consequently, demand pressures increasingly resulted in increases in prices instead of real output.

The Keynesians believed that too much saving in the economy was more of a danger than too little.[4/] The Keynesian bias against saving led to declines in saving rates, capital formation, and productivity growth and to a deteriorating economic performance. The Keynesian Phillips curve postulated an inverse relationship between inflation and unemployment--if society wants less inflation it has to put up with more unemployment. Over time the Phillips curve began to change its slope so that there arose a direct relationship--more inflation meant more unemployment and vice versa. The year 1979 capped a four-year period of expansion, but the unemployment rate in that year was nearly one full percentage point higher than the recession year of 1970. From 1979's inflation rate of 13.3 percent, one could not help but look back wistfully to 1970, when the inflation rate of 5.9 percent was regarded as so "intolerable" that the Congress passed legislation enabling the President to impose wage and price controls.

Neglect of the supply-side of the economy caused productivity growth to decline. The rate of growth of labor productivity fell off sharply starting in the late 1960s. The annual growth of output per worker averaged 3.1 percent for the two decades 1948-68 but declined to 2.1 percent between 1968-73. From 1973-80, productivity growth in the private business sector averaged only 0.6 percent per year--one fifth of the rate over the 1948-68 period. Productivity actually declined in 1979 and

1980, when cyclical developments combined with a declining trend in productivity growth.

The rate of growth in the capital-labor ratio and the real net capital stock similarly declined. The capital/labor ratio is the amount of capital available to each worker in the labor force. The more capital a worker has access to, the higher the marginal productivity of his labor.

Between the years 1948-68 the capital-labor ratio grew at an average annual rate of 3.2 percent. From 1968-73 it slowed to 1.7 percent and from 1973-80 it grew on average only 0.7 percent a year. The standard explanation for the decline in the capital-labor ratio is a rapidly growing labor force due to the coming of age of the baby-boom generation and the influx of women and immigrants as job-seekers.

The growth of the work force may serve as a partial explanation, but it masks a slowdown in the rate of capital formation. The slowdown in the growth of capital formation occurred even though the ratio of gross business investment to GNP has been increasing over the years. The measure of gross investment is misleading, because an increasing share consists of capital replacement. The composition of capital spending has shifted over the years to shorter-lived assets, which depreciate at a faster rate.

The gross investment measure also reflects a larger volume of capital being depreciated. The share of net investment has trended downward, and a portion of that net investment has been directed towards meeting federally mandated regulations and environmental standards. Annual growth of the net capital stock averaged only 3.3 percent over the 1973-80 period, one percentage point less than earlier in the postwar period.

Many people blame the Arab oil embargo in 1973 and the subsequent energy price increases as the major cause of our productivity slide, but this fails to explain why our leading trading partners, almost all of whom are more dependent on energy imports than the United States, outperformed us in productivity growth.

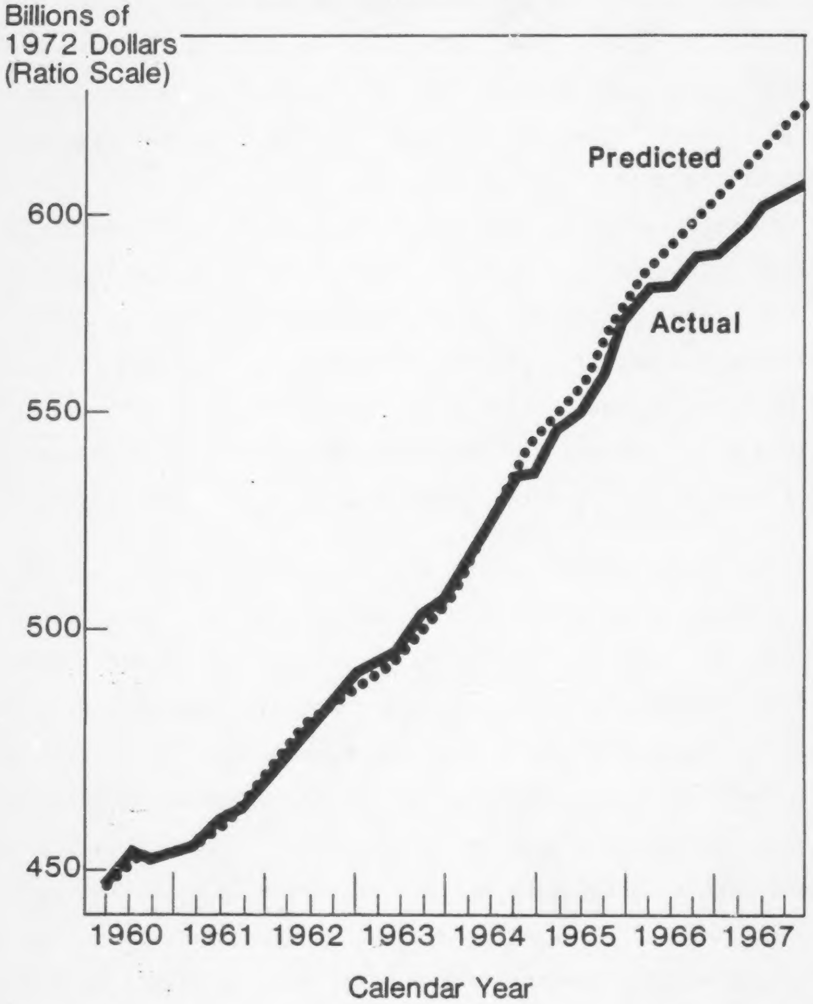
International productivity data for the manufacturing sectors prepared by the U.S. Department of Labor show a 1.7 percent rate of growth for the United States between 1973 and 1982 compared with 7.2 percent for Japan, 4.5 percent for France, 3.6 percent for the Federal Republic of Germany, 3.7 percent for Italy and 1.8 percent for the United Kingdom. Only Canada, with a 1.6 percent growth rate, lagged behind the United States.

Kennedy Tax Cuts and Supply-Side Growth

Theory provides a clear link between the relative price effects of taxation, the rate of capital formation, and the performance of the economy, and there is important empirical evidence to back it up. The 1964 Kennedy tax rate reductions have been thoroughly analysed from a Keynesian perspective which ignores the supply-side effects and the changes in relative prices that actually took place. The economic boom that resulted from the Kennedy tax rate reductions has been misinterpreted as a consumption-led expansion caused by higher spending from the tax cuts. In reality, the opposite occurred. As the chart shows, after the marginal tax rate reduction went into effect, people

Real Consumer Expenditures

Actual Compared with Predicted Values
from a "Keynesian" Consumption Function



spent a smaller percentage of their income. In 1964, actual consumer expenditures dipped below the trend rate predicted by a Keynesian consumption function. By 1967, consumption was at least $17.5 billion below the previous trend--a sum larger than the size of the personal tax cut (measured in constant dollars).

People were actually consuming a smaller percentage of their income and saving a larger percentage after the tax rate reduction than before. Following the tax reduction there was a signifcant increase in the real volume of personal saving, and the personal saving rate reversed its decline since the early 1960s and rose sharply. The personal saving rate remained high for nearly a decade until rising marginal tax rates pushed it down.

In 1964 real personal saving rose $6.6 billion above the trend growth prior to the reduction in marginal tax rates. The gain in saving was 74 percent of the tax cut. In the next two years saving increased $10.2 billion and $10.8 billion above the previous trend, a gain equal to 72 percent of the tax cut. In 1967 saving was $19 billion above the previous trend--a gain equal to 121 percent of the size of the tax cut.[5/]

The saving increase released real resources from consumption and allowed a rapid growth of business investment. In real terms, capital spending (for both the expansion of the capital stock and the replacement of worn out capital stock) had grown at an annual rate of 3.5 percent during the 1950s and early 1960s through 1962. The remainder of the 1960s saw real capital spending rise over twice as fast, increasing 7.2 percent annually. The rate of growth from 1963 to 1966 was especially marked. While growth was high in the corporate sector, small business investment showed the greatest improvements.

The acceleration in investment greatly enhanced the economy's ability to produce. The net stock of capital had grown 3.8 percent annually between 1949 and 1963, but with the tax cuts it rose to a 5.5 percent growth rate for the remainder of the decade. Keynesian economists claim that the investment boom resulted from the investment tax credit, but the sharp rise in investment could not have taken place if consumers had not released resources from consumption by saving a larger share of their incomes.

Keynesians developed a relationship between actual GNP and what they call "potential" GNP. The relationship is based on their belief that economic growth is determined by the level of demand. The government can increase demand, either with a tax cut or a boost in government spending, and thereby push actual GNP closer to potential GNP. Once the ceiling of potential or full-employment GNP has been reached, the Keynesians believe that further attempts to stimulate the economy will result in production bottlenecks and inflation.

Keynesians credit the 1964 tax cut with raising GNP by $25 billion by mid-1965 and by $30 billion by the end of the year. But Edward Denison, who is known for his Keynesian models of the economy, estimated that the gap between actual and potential GNP was only $12 billion--the size of the Kennedy tax cut. How could a $12 billion gap accomodate a $30 billion expansion based on increased demand and unused capacity? If Denison's estimate is approximately correct, the substantial expansion that followed the Kennedy tax cut had to be based on a supply-side response to the higher aftertax rates of return earned by productive activities.

The Keynesian advisors to President Kennedy wanted to stimulate the economy to its full potential. They chose a policy that they thought would stimulate consumer spending, and the conventional wisdom today still holds that the resulting boom was consumption-led. The evidence shows, however, that what the policymakers really got was a burst of saving and investment activity that spurred the economy beyond fuller utilization of existing resources to faster growth of the ability to produce. Far from being a consumption-led expansion, real consumer spending actually declined as a percentage of income. Saving, investment, and tax revenues rose strongly.6/

Soaking the Rich with Tax Cuts

An equal reduction in marginal tax rates reduces taxes by the same proportion for all income levels and initially leaves the shares of the tax burden falling on "rich" and "poor" unchanged. However, since disincentives are greater the higher the bracket, a proportional reduction in marginal tax rates improves incentives the most for the "rich," encouraging them to earn and report more income. As they do, their share of the tax burden rises. The Internal Revenue Service's Statistics of Income show this to be the case whenever marginal tax rates are reduced.

For example, Gwartney and Stroup examine two cases of proportional marginal income tax rate reductions, the Mellon tax cut of the 1920s and the Kennedy tax cuts of the 1960s.[7/] In the case of the Mellon tax cut, named after Treasury Secretary Andrew Mellon, marginal tax rates that reached 73 percent in 1921 were reduced to a top rate of 25 percent by 1926. The effect on the economy was positive: "The economy's performance during the 1921-26 period was quite impressive. Price stability accompanied a rapid growth in real output."

Gwartney and Stroup found the shift in the tax burden equally impressive. By 1926 personal income tax revenues from returns reporting $10,000 or less dropped to 4.6 percent of total collections, compared to 22.5 percent in 1921. In contrast, the percentage of total income tax revenues from returns by people with incomes of $100,000 or more rose to 50.9 percent in 1926 from 28.1 percent in 1921. The evidence supports the conclusion that "as a result of the strong response of high-income taxpayers, the tax cuts of the 1920s actually shifted the tax burden to the higher income brackets even though the rate reductions were greatest in this area."[8/]

Their analysis of the Kennedy tax rate reductions (which reduced the top rate from 91 to 70 percent) yields similar results. In 1965, after the tax rate reductions, collections from the highest 5 percent of income earners rose to 38.5 percent of the total from 35.6 percent in 1963. In contrast, the proportion of income tax revenues from the bottom 50 percent of tax returns fell from 10.9 percent in 1963 to 9.5 percent in 1965.

In testimony before the Joint Economic Committee of

Congress on June 12, 1984, Gwartney noted that the Economic Recovery Tax Act of 1981 (ERTA) is yielding similar results. The reduction of the top marginal tax rate from 70 to 50 percent cut the tax rates paid by high income earners by as much as 28.6 percent, but tax revenues collected from the rich increased. Revenues from the top 1.36 percent of taxpayers, the group that most benefited from the rate reductions, rose from $58.0 billion in 1981 to $60.5 billion in 1982. The proportion of the total income tax collected from the top 1.36 percent of taxpayers rose to 21.8 percent in 1982 from 20.4 percent in 1981.

The tax liability of low income taxpayers fell both in absolute terms and as a percent of the total. Taxes paid by the bottom 50 percent of income earners fell from $21.7 billion in 1981 to $19.5 billion in 1982, and the share shrank from 7.6 percent in 1981 to 7.0 percent in 1982. Gwartney concludes that

> far from creating a windfall gain for the rich, as some have charged, ERTA actually shifted the burden of the income tax toward taxpayers in upper brackets, including those who received the largest rate reductions as the result of the 50 percent rate ceiling.9/

This seems to be a general conclusion supported by the empirical results of all marginal income tax rate reductions in the United States. Far from "soaking the rich," high marginal income tax rates discourage people from making their best effort and serve as a barrier to upward mobility and financial independence.

Economists Move to the Supply-Side

Despite the supply-side footprints left by previous tax rate reductions, some Keynesians still argue that there is no proof that people respond to marginal tax rate reductions by working or saving more. Some Keynesians have begun to acknowledge that society needs to save more,[10/] but many still see tax cuts as an inefficient and ineffective tool. They argue that people have relatively constant levels of saving which are inelastic to changes in the aftertax rate of return. Similarly, they argue that people will work no more, and perhaps even less, after a tax cut because they experience an increase in aftertax income.[11/] Several recent studies contradict this viewpoint, showing that people can and do respond to better incentives by increasing their saving and work efforts.

In "Taxation, Saving, and the Rate of Interest," Michael Boskin found that the total elasticity of saving (income and substitution effects combined) was positive and on the order of 0.3 to 0.4. While the size of this response has since been disputed by other studies, his findings are nevertheless interesting and valuable. On the basis of his research Boskin predicted that raising the aftertax rate of return to capital would "increase income substantially" and "remove an enormous deadweight loss to society resulting from the distortion of the consumption-saving choice."[12/]

Another interesting conclusion of his study is that not only will people respond positively to a change in the relative price of saving but that a larger share of total income will be transferred from capital to labor. Boskin confirms earlier studies indicating that the elasticity of substitution between capital and labor is less than one. If the elasticity of substitution between capital and labor is less than one, then an increase in the capital-labor ratio (following an increase in saving) leads to a corresponding increase in labor's share of total income. Boskin wrote that

> the current tax treatment of income from capital induces an astounding loss in welfare due to the distortion of the consumption/saving choice . . . reducing taxes on interest income would in the long run raise the level of income and transfer a substantial portion of capital's share of gross income to labor.[13/]

Larry Summers in a study for the National Bureau of Economic Research modified three different theoretical models in order to better monitor changes in saving as a result of changes in the rate of return. He then conducted empirical analysis using the three alternative models, finding that "all three suggest a significant response of savings to changes in the rate of return."[14/]

In a recent study of the effects of the 1981 tax reduction, Allen Sinai, Andrew Lin and Russel Robins found that private saving is influenced by the aftertax rate of return and that the economy would have performed much more poorly in 1981-82 had it not been for the 1981 tax rate reduction.[15/] They also found that the cash flow effects of the tax cuts reduce the burden of loan repayment and interest charges on debt, thereby strengthening home and business balance sheets.

Using an augmented Data Resources model of the U.S. economy incorporating previously neglected effects of aftertax interest rates on saving, investment and consumption, Sinai and his associates found that the net tax reductions that were introduced by the Reagan Administration raised business saving by $27 billion during 1981-82 and will add $181 billion over the 1981-85 period. The effect on personal saving is even more dramatic.

Saving rises above the baseline trend by $48 billion in 1982 and $136 billion in 1985, producing a cumulative increase in personal saving of $402 billion for the 1981-85 period.[16/]

In a powerful vindication of the position taken by Treasury Department supply-siders, the economists conclude: "These results illustrate the sensitivity of saving to the changes in taxes and that ERTA is a program with major effects on personal saving." The economists found that in the absence of the tax cut, "the U.S. economy would have performed considerably worse in 1981 and 1982 than actually was the case," with an additonal loss in real GNP of about 1.6 percentage points. They concluded that the "evidence indicates that ERTA has had a major impact on U.S. economic growth."

In 1983, despite highly publicized fears expressed by the chairman of the Council of Economic Advisors and the chairman of the Federal Reserve Board that high interest rates would produce a lopsided and weak recovery, the recovery was well-balanced and the economy rebounded strongly. According to the 1984 *Economic Report of the President*, interest sensitive categories such as consumer durables, business fixed investment, residential investment and inventories all contributed to GNP growth in proportions that either matched or bettered the average of postwar recoveries. One category of nonresidential fixed investment--investment in producer's durable equipment--performed particularly well, making three times its average postwar contribution to the first year of recovery.

The other component of nonresidential fixed investment--

structures--contributed slightly less to the first year of recovery for the striking reason that it barely fell during the recession. Throughout most of the recession, investment in structures remained well above its pre-recession level, instead of declining as it did in the seven previous cycles. Non-residential construction showed little effects of recession because structures was the sector least affected by the 1982 tax increase.

As a result of improved cash flow from the 1981 tax cut, the credit crunch, which many predicted would result from the budget deficits, did not occur. According to the Economic Report of the President:

> The nonfinancial corporate sector did not place significant demands on the credit markets in 1983. As cash flow rose markedly due to the strength of the recovery, corporations obtained most of their funds from internal sources. Despite increases in business fixed investment outlays and a move from inventory liquidation to accumulation within the year, the non-financial corporate sector is estimated to have borrowed about $33 billion in the first three quarters of 1983, well below the amount borrowed over the same period in 1982. 17/

The source of the rise in interest rates was not Treasury borrowing crowding the private sector out of the financial markets, but the Federal Reserve Board's decision to tighten money supply growth. According to the economic report, "In the middle of 1983 the Federal Reserve became less accomodative in its provision of reserves. As a result, interest rates rose moderately."18/

Other recent studies and experiments show that people's decisions about the allocation of time are affected by the relative prices of work and leisure. Jerry Hausman, for example, has devoted much time and energy to studying the effect of taxes on work decisions. In a Brookings Institution study, Hausman reports:

> Although income and payroll taxes account for 75 percent of federal revenues, most economists have concluded that they cause little reduction in the supply of labor and do little harm to economic efficiency. The results of this study contradict that comforting view. Direct taxes on income and earnings significantly reduce labor supply and economic efficiency. Moreover, the replacement of the present tax structure by a rate structure that proportionally taxes income above an exempt amount would eliminate nearly all of the distortion of labor supply and more than half of the economic waste caused by tax-induced distortions.19/

In another study Hausman finds that, using 1975 data, desired labor supply was 8.2 percent lower than it would have been without federal income taxes, FICA taxes and state income taxes. He notes in particular that

> the effect of the progressiveness of the tax system is to cause high wage individuals to reduce their labor supply more from the no tax situation than do low tax individuals. . . . Of course, this pattern of labor supply has an adverse effect on tax revenues because of the higher tax rates that high income individuals pay tax at.20/

Measuring the effects on labor supply of the tax system and of a 10 and 30 percent reduction in marginal income tax rates, Hausman reports that a person earning a nominal wage of $3.15 an hour worked 4.5 percent less than he would have in the absence of taxes. He would choose to work 0.4 and 1.3 percent more after 10 and 30 percent tax rate reductions, respectively. As income increases, the responses get larger. Taxes cause a person earning $10 an hour to reduce the number of hours worked by 12.8 percent. A 10 and 30 percent reduction would induce him to increase his work time by 1.47 and 4.6 percent, respectively.

Another interesting result of Hausman's work is his calculation of the "deadweight loss" incurred by the imposition of the progressive income tax system. He defines deadweight loss as the amount an individual would need to be given to be as well off after the tax less the amount of tax revenue raised. Hausman finds that there is an average deadweight loss equivalent to 22.1 percent of tax revenue collected, which is income that is "lost" because of the presence of taxes. As income increases, so does deadweight loss. A person earning $10.00 an hour, according to Hausman, has a deadweight loss of 39.5 percent of tax revenue.

The impact of income maintenance programs on the work effort of low income earners also clearly demonstrates the relative price effects of taxation that supply-side economists have stressed. The Seattle/Denver Income Maintenance Experiments (SIME/DIME) was the fourth and most comprehensive of the experiments undertaken by the government in the 1960s and 70s to examine the effects of a cash transfer program or negative income tax on low income earners. People were given cash transfers of varying generosity which guaranteed them incomes whether they worked or not. Their subsidies were taxed so that when they began earning income above a certain level, the subsidy would gradually be reduced to zero. The purpose of the study was to determine whether a cash transfer would be a more efficient way to transfer income to the poor than the variety of welfare programs that were already in existence.

The negative income tax lowers the relative price of leisure and, not surprisingly, the SIME/DIME results, published in May 1983, show "a significant negative effect on hours worked per year." Married males participating in the three-year cash transfer programs worked an average of 7.3 percent less than they would have in the absence of the negative income tax. Those who participated in the five-year program reduced their labor supply 13.6 percent, demonstrating that work disincentives rise with the permanence of income support programs. Wives and female heads of household showed a larger response to the cash transfer program. The report noted that

> by the end of the first post-treatment year, labor supply for NIT-eligible husbands had again returned essentially to the same level as that for controls, indicating strongly both that the observed response was indeed a result of the treatment and that husbands can adjust their labor supply fairly rapidly to changed incentives.21/

Growth and Fairness through a Flat-Rate Tax

The existing U.S. tax code is unaffordable because of its adverse effects on relative prices. A broad-based flat-rate tax, especially one that exempted saving from the tax base, would remove the current disincentives to earn additional income from work, saving, investment and risk-taking. The cost to the economy of the distortions caused by the differential treatment of investment in the current tax code would also be eliminated by a broad-based flat rate tax.

Any tax system should meet a minimum of three goals: it should be simple and fair, it should collect adequate revenues, and it should minimize its own burden on the economic vitality of the tax base. Despite the reforms of 1981, the present tax system still fails to meet any of these goals.

The present tax system is not based on the principle of fairness but on the "ability to pay" argument. Fairness says that a person who earns twice the median income should pay twice as much in taxes. The ability to pay argument claims that the government should be able to extract, for example, five times as much in taxes from a person who makes twice the median income simply because he is better able to withstand the burden. The ability to pay argument introduces massive economic disincentives into the economy, because it increases the rate of penalty as additional effort is expended. The current tax system even violates the ability to pay argument. Bracket creep has pushed middle income earners into marginal tax brackets that formerly pertained only to the rich. As inflation and economic growth moved the people higher into the progressive tax system, the disincentives of progressivity spread into the population as a whole. The fairness principle is further breached because different kinds of income are taxed differently, as is marital status.

The tax system also discourages revenue collection and depresses the tax base. People are encouraged to make investments that minimize their taxes rather than maximize their income. In a recent publication the House Democratic Caucus, echoing years of complaints by supply-side economists, noted the heavy economic cost of the current tax system:

> The current tax code distorts investment decisions so that economically desirable investments often appear less attractive than those where tax incentives inflate profitability. Section after section tells new investors what lines of business to enter, tells existing corporations how to go about their work, and puts a heavy tax on the profits of successful and productive corporations. The whole system makes no economic sense.22/

It is refreshing to see that at least some Democratic Congressmen no longer think exclusively of redistribution when they call for tax reform. Perhaps they are beginning to realize that redistribution takes place through the expenditure, and not the revenue, side of the budget.

The third goal for tax policy, collecting adequate revenue, cannot be achieved independently of the other two goals. If taxpayers feel that the system is unfair, they are more likely to engage in tax avoidance. The large underground economy that has developed in the United States is testimony that many Americans no longer believe that the tax system is worthy of support. In the United States today tax avoidance is a big business in which many participate, from the carpenter who willingly accepts a lower payment provided it is in cash, to the Wall Street entrepreneur who devises ingenious but hopelessly unproductive tax shelters, to the Washington lawyer/lobbyist who bargains for special tax breaks for his clients.

The size and strength of the economy is the basis for the government's budget. The economy's strength determines how much the government must spend on such things as unemployment benefits, public housing and income support programs and how much it can spend on defense, education, and public investment in roads and bridges. The size of the federal budget in relation to GNP depends not only on the budget, but also on the economy. Obviously, it is much easier for a government to "live within its means" if the economy is large, healthy and growing.

In a broad-based low flat-rate system, marginal and average tax rates are equivalent, and the economic distortions that differential tax treatment causes are reduced to a minimum. A "revenue neutral" tax reform, in which the higher revenues from a broader base are fully offset by lowering the tax rate, would result in higher Treasury revenues because of the dynamic effect on the economy of better incentives and reduced investment distortions. This would allow the budget to be balanced without raising the tax burden.

Exempting saving from the tax base would add a big boost to investment, capital formation and productivity. For too long and for too many people, the government's policies presented an ultimatum: go into debt or go broke. Tax law that encourages debt over equity is a source of high interest rates and low capital formation. Exempting saving from the tax base would treat income saved the same as income consumed.

Economic policymakers may be faced with an important opportunity. The healthy results of the initial supply-side reforms in 1981 are bound to add momentum to additional positive reforms. Now is the time to guarantee the future by fundamentally reforming the tax system.

Notes

1. See Paul Craig Roberts, "The Breakdown of the Keynesian Model," *Public Interest*, No. 52, Summer 1978.

2. See Norman Ture, "Supply-Side Analysis and Public Policy," in David G. Raboy, ed., *Supply-Side Economics* (Washington, D.C.: Institute for Research on the Economics of Taxation, 1982), and Jack Kemp, "The Tax Bias Against Savings Shrinks Everyone's Pie," *Washington Star*, September 21, 1975.

3. In March 1984 the U.S. Treasury Department published a study, "The Effects of Deficits on Prices of Financial Assets: Theory and Evidence," which suggests that in general taxes more effectively crowd out investment than do budget deficits.

4. See, for example, Congressional Budget Office, "Closing the Fiscal Policy Loop: A Long-Run Analysis," (Washington, D.C.: U.S. Government Printing Office, 1977).

5. See Paul Craig Roberts, *The Supply-Side Revolution: An Insider's Account of Policymaking in Washington* (Cambridge, Mass.: Harvard University Press, 1984), p. 79.

6. For a detailed discussion, see *The Supply-Side Revolution*, pp. 69-81.

7. James Gwartney and Richard Stroup, "Tax Cuts: Who Shoulders the Burden?," *Economic Review*, Federal Reserve Bank of Atlanta, March 1982, pp. 20.

8. *Ibid*, p. 26.

9. James Gwartney, "Tax Rates, Taxable Income and the Distributional Effects of the Economic Recovery Tax Act of 1981," testimony before the Joint Economic Committee, June 12, 1984, p. 19.

10. See Alice M. Rivlin, ed., *Economic Choices 1984* (Washington, D.C.: Brookings Institution, 1984).

11. These arguments are logically inconsistent. If people in general respond to a tax cut by reducing their working hours, total income would fall. See Roberts, "The Breakdown of the Keynesian Model" and *The Supply-Side Revolution*.

12. Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, April 1978, Vol. 86, no. 2, pt. 2, p. S 3.

13. *Ibid*, p. S 25.

14. Larry Summers, "Tax Policy, the Rate of Return, and Savings," "Working Paper #995," National Bureau of Economic Research, September 1982, p. 43.

15. Allen Sinai, Andrew Lin, and Russel Robins, "Taxes, Saving, and Investment: Some Empirical Evidence," *National Tax Journal*, September 1983.

16. *Ibid*, p. 23.

17. Council of Economic Advisors, *Economic Report of the President, 1984* (Washington, D.C.: U.S. Government Printing Office, 1984), p. 193.

18. *Ibid*, p. 195.

19. Jerry Hausman, "Labor Supply," in Henry J. Aaron and Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior* (Washington, D.C.: The Brookings Institution), 1981, p. 27.

20. Jerry Hausman, "Taxes and Labor Supply," "Working Paper #1102," National Bureau of Economic Research, March 1983, p. 46.

21. Final Report of the Seattle-Denver Income Maintenance Experiment, SRI International, U.S. Department of Health and Human Services, May 1983, p. 13.

22. National House Democratic Caucus, "Renewing America's Promise: A Democratic Blueprint for Our Nation's Future," January 1984, p. 15.

TAX RATES AND REVENUES / GEORGE GILDER

What Ronald Reagan DOESN'T KNOW about his own achievements

THE U.S. ECONOMY is currently in the midst of a world-leading surge of productivity growth, innovation, capital formation, and employment. The United States is applying high technology nearly 50 per cent faster than Europe or Japan. Spending on capital equipment—led by electronic gear—set an all-time record for the first year of a recovery, rising at three times the average pace of first-year upturns since World War II. As a result of President Reagan's tax policies, the rich have been paying decisively the highest share of income taxes they have paid in 11 years. Outside of the desperate sloughs of the welfare culture, which the politicians in their famous compassion refuse to change, the poor are rapidly leaving poverty and are paying their smallest share of income taxes in more than a decade. In 1983 the U.S. created four million new jobs—a peacetime record—and is now employing a record 61 per cent of the working-age population, a level some 15 per cent higher than its European rivals'.

Why on earth doesn't President Reagan know all this? Why does he stumble and grope at a press conference when asked a question about the fairness of his tax program or the performance of the economy? Why do leading Republicans believe they have to raise tax rates to get more revenue when lowering rates in the high brackets has achieved this result while expanding employment and growth? Why do leading economists speak of sluggish productivity growth and suggest that the U.S. continues to lag behind Europe in this key index?

The answer to all these questions is simple. From the President on down, the Republicans see the economy through the eyes of analysts who are blind to technological change, cannot measure a system on the move, and thus have no idea what is going on in America.

Take, for example, the recent silliness from the Congressional Budget Office (CBO), which made the front page of several prominent newspapers, was widely featured in the leading news weeklies, and was used by the press to harry the President at a news conference.

At that conference, a reporter cited the CBO finding that families with incomes of more than $80,000 will gain $8,390 from the Reagan program in 1984 while families with incomes of less than $10,000 will lose $330. The reporter asked, "Is this fair?" President Reagan began with a perfectly valid reference to "lies, blankety-blank lies, and statistics." He should have left it at that. But then he asserted, debatably, that inflation hurts the poor the most and that his Administration has conquered inflation. Finally, he accepted the essential premise of the question by pointing out, falsely, that it had been a proportionate tax cut and that therefore the rich, who pay the most, would get the largest absolute benefit. In fact, the cut in the top rate came first, thus giving upper-bracket taxpayers the largest cut and inducing them to increase their payments the most.

This is not altogether a case of a partisan Congressional Budget Office attacking a Republican President. Although this particular study was commissioned by Democratic Senator Lawton Chiles of Florida, the CBO is now led by Rudolph Penner, a Republican, formerly at the American Enterprise Institute. Nor did the President's ineffectual answer reflect a failure to be adequately briefed by his economists. Most of the President's economists could have answered no more effectively than he did. From the Bureau of Labor Statistics to the Council of Economic Advisors, most of the Administration's analysts essentially agree with the President's answer—and with the CBO. They are confounded by the dynamics of an entrepreneurial economy where tax-rate cuts reliably improve the distribution of income and increase payments by the rich.

The CBO and the President's advisors both believe that people stand still for taxes. Therefore if you drop the top bracket by 29 per cent, as the Administration did in 1981, top-bracket taxpayers will pay less. All world history shows this proposition to be false, but nearly all the world's economists believe it, including, most notably, the accountant-economists in the Administration.

In fact, in a dynamically changing economy where families are continually moving in and out of wealth and poverty, people do not stand still for anything except possibly a Kodak or an economist, and nothing makes them move faster than a tax hike. The very concept of a static body of "rich" and "poor" is a Marxist fantasy to begin with. The only way you can create a static class of poor people is through a welfare system that destroys their families and pays them to stay poor. The only way you can create a static class of rich people is to tax new income so fiercely that entrepreneurs are prevented from challenging established wealth. Although U.S. policymakers have often moved toward such a system, the Reagan Administration

---

Mr. Gilder's new book is The Spirit of Enterprise, *which will be published in September by Simon & Schuster. It is an alternate selection of the Book-of-the-Month Club and a main selection of the Fortune Book Club.*

has been attempting to dismantle the welfare trap for the poor and the tax trap for the entrepreneurs. While this policy leads the rich to pay more taxes and the poor to escape poverty, the static models—utterly irrelevant to the real world but comfortable to tax raisers and convenient to economists—can measure only a drop in payments by the rich and a drop in benefits for the poor.

When tax rates are cut in the top brackets, people earn and report far more income at this level and pay far more xes. Highly progressive tax rates do not redistribute income; they redistribute taxpayers. Facing a rate above 25 per cent, taxpayers simply report less taxable income. They flee to tax shelters or to the underground economy, into foreign banks and tax havens, Mercedes Benzes and political-action committees, and onto yachts, beaches, and golf courses. They twist their finances into low-caloric pretzels and serve them to the IRS. Tax considerations impinge on every investment decision they make.

When top-bracket tax rates are cut, taxpayers begin to invest with a greater interest in the ultimate taxable yield. Even though they continue to invest in shelters, they focus on vehicles with a real return rather than simply a convenient loss. The overall result is that they pay more taxes, even when, as over the last two years, they increase their participation in explicit shelters—even when, as in the recent recession, their real income actually drops. In 1982, for example, approximately $3.5 billion in additional funds was invested in shelters—not a large amount compared to the deficit but a signal of seriously distorted investment incentives. The bulk of the new shelter funds poured through the chief loophole in the new tax act: 15-year accelerated depreciation of buildings that actually rise in alue. But explicit shelter activity is dwarfed by the impact of high tax rates on every investment decision made in the economy. The drop in the top rate oriented investors in 1982 toward seeking taxable returns to a greater degree than they did in 1981. As a result the prices of real estate, gold, and collectibles dropped during 1982, and the price of items with a able yield, such as stocks and bonds, rose. The effect of these changes was a rise in the taxes paid in the top brackets even during a recession year that saw real incomes drop, particularly in the top brackets.

In 1982, for example, in the midst of recession, 48 per cent more households reported adjusted gross incomes of more than $1 million, and they paid 42 per cent more taxes and a 37.4 per cent higher share of taxes than in the pre-recession, pre-tax-cut year of 1981. Such a response was easily predictable. After the Kennedy tax cut of 1964, payments in the top brackets rose by 80 per cent, and after the Coolidge tax cuts of the mid-1920s, payments by the rich rose by some 200 per cent, and the share of taxes paid by the rich rose from 28 per cent to 63 per cent.

Yet this CBO study explicitly acknowledges that its "revenue estimates are static estimates: They are based on the somewhat arbitrary assumption that such changes in the tax code do not have significant effects on general taxpayer behavior or otherwise on the economy at large." The assumption is certainly arbitrary. As Lawrence Pratt of the American Institute for Economic Research has written, the CBO approach is like assuming that "motorists' behavior is unaffected by police cars and street signs." Or that housewives don't cut their purchases of asparagus in January.

In other words, the CBO economists assume from the outset that the only reason to change tax rates is to redistribute income, and they assume in the case of the Reagan tax cut that the shift is from the poor to the rich. They utterly ignore the argument, made endlessly by advocates of reduced rates, that lower rates, particularly in the top brackets, foster economic growth and progress and induce the rich to pay more taxes.

Now that the rich are indeed once again paying more taxes after a tax-rate cut—and paying their highest share in 11 years—the supply-side argument has been entirely vindicated. But neither the economists at the CBO nor the economists within the Administration will accept these data. Both advocate tax hikes and fear that acceptance of these numbers would lead to further tax cuts—and larger deficits—in 1984. Thus economists in the Administration systematically edit out of speeches all references to this key policy success by the Administration and allow President Reagan to flounder pathetically before the press—and the television audience—on the so-called fairness issue, which Walter Mondale has already indicated will be a central theme of his campaign if he indeed receives the Democratic nomination.

More disturbing are the CBO estimates for the future. The CBO shows that through the predicted rise of incomes alone, net of inflation, the share of taxes paid by those with incomes of more than $40,000 will increase between 1982 and 1985 from 46 to 65 per cent of total taxes.

**If Congress is unwilling to
control spending, the only way
it can reduce the deficit
is by further reductions in
the top tax rate**

These estimates are disturbing because they suggest that marginal tax rates will rise on this group. As the rates statically considered do rise, the revenues will predictably fall below expectations, and Rudolph Penner and his allies will return for more taxes in 1986. The poor will end up paying more, not less, of total taxes.

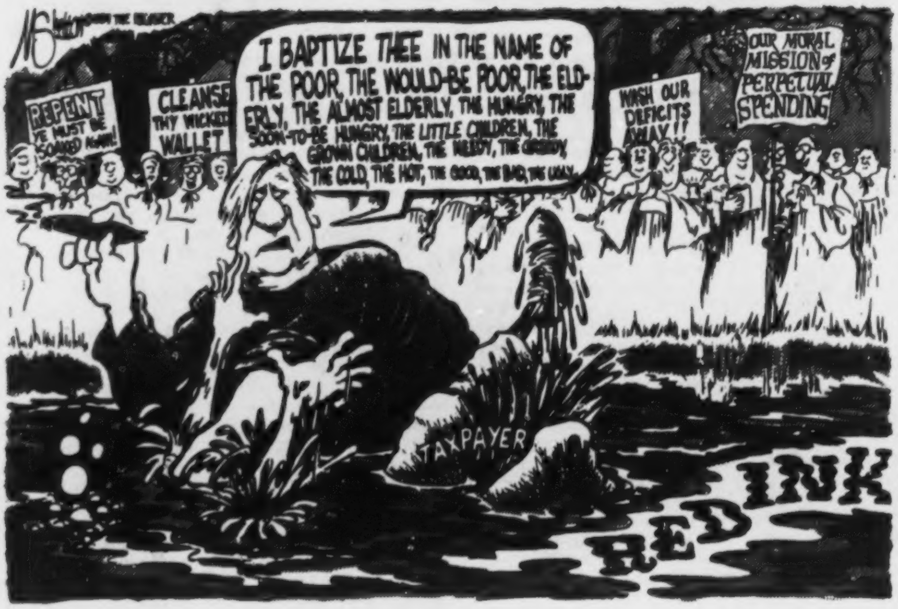
The problem is epitomized by the CBO assumption that "The percentage of income taxes paid by households in the $80,000 and over category was reduced in 1982 largely by the ERTA [Economic Recovery and Tax Act] reduction in the maximum statutory tax rate on all income from 70 per cent to 50 per cent." Yet, in fact, from two sets of Treasury data it can be seen that this group substantially increased its share of tax payments in 1982. The latest Treasury data show that households with incomes above $75,000 increased their payments by 7 per cent, while households with incomes below $75,000 decreased their payments by 4.8 per cent. This result was affected by inflationary bracket creep at the lower end of the income scale. But the increase in the share of payments was largest in the highest brackets, those farthest above the reach of bracket creep. In short, the CBO estimates are totally unsupported by upper-bracket data. Since these data were fully available to the CBO, its failure to use them calls into question the competence of the entire study.

Administration economists for the last two years have dismissed as a statistical anomaly all evidence that the President's tax cuts are working in accordance with the Laffer Curve. In particular, they questioned the value of the only available index of payments by the rich—non-withheld receipts of the Treasury, net of refunds—as misleading on various technical grounds. They said the rise in 1982 was attributable to higher penalties on shortfalls in estimated quarterly payments. Even if their argument were correct, however, the higher penalties would merely have shifted payments into 1982 from April 1983. However, including April 1983, the rich still paid decisively their highest share of income taxes in more than a decade. Moreover, the share of income taxes paid by the rich rose again for all of 1983. Thus, all the contentions of liberal economists that the higher share of taxes paid by the rich was an anomaly of the recession are refuted by the evidence that the rich increased their share of payments again during the recovery. Because this index of non-withheld payments is less affected by inflation, it is probably more dependable as a measure of the share of payments by the rich than the Treasury statistics by income group. With tax rates rising in 1984 the share of payments by the rich has recently begun to decline, though it remains substantially higher than at any time between the tax hikes of the early 1970s and the tax cut of 1981.

All this evidence leads inexorably to the conclusion that if Congress is completely unwilling to control spending, the only way it can reduce the deficit is by further reductions in the top tax rate. Tax shelters and other tax-related investments, particularly depreciable buildings that actually appreciate in value, still abound in the portfolios of otherwise productive Americans. It would be possible to spur new growth and induce a veritable flood of new revenue by dropping the top rate to a sensible level.

Missing all these key responses to taxation, the CBO study assumes that revenues would have been higher under the old rates. Thus the CBO argues that if the Carter policies of steadily rising tax rates had remained in effect, the deficit would have dropped to $39 billion by 1987 rather than rising by $180 billion as an effect of Reagan's tax cuts. However, Canada's per-capita deficits, for example, are nearly double ours, and its growth rate less than one-half ours, after allowing its income-tax rate to rise 10 per cent since 1981. In fact, throughout the world, according to a recent World Bank study, countries with high tax rates raise less new revenue than countries with low tax rates. The CBO projections assume not only that rich people—and their accountants and tax planners—are stupid enough to pay 70 per cent tax rates, but also that, when they do, they remain rich enough and dumb enough the next year to continue paying them. The CBO study imagines that the U.S. economy would have recovered as vigorously while tax rates on both individuals and corporations soared by some 40 per cent in four years. Such assumptions are not economics; they are either incompetence or deceit.

The other CBO contentions are equally fatuous. According to the study, the average family earning less than $10,000 lost $330 as a result of Reagan Administration policies. This finding ignores the small matter of four million new jobs that took people out of poverty at a rapid


I BAPTIZE THEE IN THE NAME OF THE POOR, THE WOULD-BE POOR, THE ELDERLY, THE ALMOST ELDERLY, THE HUNGRY, THE SOON-TO-BE HUNGRY, THE LITTLE CHILDREN, THE GROWN CHILDREN, THE NEEDY, THE GREEDY, THE COLD, THE HOT, THE GOOD, THE BAD, THE UGLY
REPENT YE MUST BE SOAKED AGAIN!
CLEANSE THY WICKED WALLET
WASH OUR DEFICITS AWAY!!
OUR MORAL MISSION of PERPETUAL SPENDING
TAXPAYER
RED INK

Distributed by King Features Syndicate

pace in 1983, and the nearly five million net new jobs created under the Reagan Administration. It ignores the drop in inflation that slowed the move of the working poor into the bottom bracket, which was occurring at a rapid pace under Carter and would have continued under pre-Reagan tax policies and inflation rates. The finding also ignores the current entrepreneurial boom, including record minority business starts, venture-capital outlays, and technological creativity. A 1981 study by the GAO of 72 companies begun with $209 million in venture capital after the 1978 cut in the capital-gains tax indicated that they had directly generated 135,000 new jobs, $450 million in new tax revenues, and $900 million in new exports in four years. By that standard the $7 billion in new venture outlays since the Reagan tax cuts will directly generate four million new jobs, $15 billion in new taxes, and $27 billion in new exports. But the real benefits in innovation and growth will be far greater. Similar gains can be expected from the growth of $8 billion in the total unexpended venture-capital pool accumulated under Reagan. All these advances on the frontiers of technological change in the world economy will both enrich the coffers of the government and accelerate the movement of the poor out of poverty.

Despite all the ministrations of the welfare state, the gap between black and white family incomes has scarcely changed in 25 years

Meanwhile the real twenty-fold increase in welfare and other social spending over the last quarter-century has achieved historic highs in family breakdown and unemployment among poor blacks in America. In 1981, the illegitimacy rate, spurred on by giving 16-year-old girls welfare payments and free apartments if they bear children out of wedlock, rose to 55 per cent of all black births. Despite all the ministrations of the welfare state, the gap between black and white family incomes has scarcely changed in 25 years, and the real gap, exclusive of welfare and in-kind benefits, has actually grown. Anyone who has studied real ghetto conditions as opposed to poverty statistics recognizes that welfare plays a key role in this tragic wastage of ghetto lives. Meanwhile, the incomes of intact black families have risen to more than 90 per cent of the incomes of comparable white families. In the face of this evidence it is simply outrageous for Democrats to attack the Reagan Administration for insensitivity to the plight of the poor.

The welfare issue has been woefully confused by the debate over the deficit. Welfare is not a significant cause of the deficit. The reason to cut welfare is not that it wastes money, but that it wastes lives. Welfare creates a wreckage of broken hearts and families, crime and unemployment, and it intensifies and perpetuates poverty in the name of compassion.

The most recent statistics on tax receipts suggest that the effects of the 1981 tax cuts are being gradually countervailed by new tax increases. To fight the current deficit, new reductions in marginal rates are needed. Otherwise the economic results—as measured by the usual economists—will appear sluggish as the election approaches. Productivity, for example, will appear to be languishing. The Administration is going to have to learn how to interpret and explain an entrepreneurial economy.

The U.S. economy is growing again in a healthy way after the tumors and suppurations of the mid-1970s. But the thrust of the growth—as manifested by increasing tax payments by the rich—is entrepreneurial: a shift out of gold, collectibles, and other diversionary investments into the risks and challenges of productive activities. The key indices of the shift are the record 600,000 new companies begun in 1983, in an entrepreneurial upsurge that accelerated into 1984; the 60 per cent rise over the last four years in public companies listed over-the-counter; and the tripling of venture-capital outlays. Most important has been the world-leading surge in high-technology purchases, made possible by what is incomparably the world's most productive and creative software industry, transforming computer hardware into ever more useful and versatile equipment.

The driving force in the recovery has been the purchases of producer durables, which rose in 1983 at three times the pace of previous recoveries of the post-World War II era and were dominated by electronic gear. Not only did these purchases rise steadily through the end of 1982 and surge into the first quarter of 1983 at a record pace while retail sales were actually declining. These computers and related gear also were radically improving the efficiency of the U.S. capital stock. But Washington is completely incapable of measuring the productivity of this gear. In fact, the Bureau of Economic Statistics (BES) has assumed for 25 years that computers have been rising in price at a rate of 1 per cent per year, when in fact computers have been dropping in price at an exponential pace as measured by their explosive improvement in quality, power, and usefulness. Joel Popkin, formerly of the BES, estimates that the error in calculating the price of computing has led to a 5 per cent cumulative underestimate of real GNP, a $150-billion-odd mistake. But the real error in measuring the growth of an economy increasingly dominated by computers, semiconductors, and other products unmeasurable by the BES is much greater.

The recent economic revival has not been a mere cyclical recovery; it has been an industrial renaissance. If the Reagan Administration is going to respond effectively to its critics, and sustain its successes, it had better hire some economists who know what's going on. With Martin Feldstein's resignation as chairman of the Council of Economic Advisors, the Administration could bring on board a powerful spokesman for its policies as the campaign approaches.

Yet the word in Washington is that the Administration will refrain from naming a new chairman in order to avoid having to defend its economic policies before Congress. At the White House, so it often seems, the economy is seen as a game, scored by the deficit, and the Administration is losing. But there is a real-world economy out there, beyond Washington's phantom numbers, and the American people are winning again in the crucial realm of industrial creativity and progress. The rest of the world, from François Mitterrand to myriad Japanese, from Soviet spies to Gary Hart's speechwriters, knows it. Why not the White House? ☐

Heritage Features Syndicate
A public policy news feature syndicate

Andrew C. Seamans Sr.
Managing Editor

Hugh C. Newton &
Herb Berkowitz,
Editorial Directors

Editor's Note: ALL CAPS DENOTES ITAL.

For National Release: June 10, 1984

"The Economy in Mind"

Tax Cut Debate Shows Reagan Staff Conflicts

By Warren T. Brookes

On June 12, the Joint Economic Committee of Congress (JEC) will hold hearings on the actual effects of the Reagan tax cut, on the "progressivity" of the tax burden, and the "fairness issue." The hearing should be an ideological rebuke to the liberal Democrats, who beat up on Reagan's "tax cuts for the rich." But, it could be an even greater embarrassment to the White House if it shows that members of the administration sought to discredit information politically helpful to the president.

This JEC hearing was prompted by a lively media debate over the impact of the actual IRS 1982 tax distribution data, showing that the effect of the first-year tax cut the rich paid a 14-percent larger share of the income tax burden, while that paid by those earning under-$20,000 dropped 12 percent, completely opposite to liberal charges. The IRS table appeared first in this column (March 25), and was subsequently presented by the WALL STREET JOURNAL (April 11), then cited in TIME magazine (April 30).

The IRS data was so totally at variance with the WASHINGTON POST's politics, it lost its cool on April 22, and published an analytical article by John Berry with the headline "IRS figures for '82 Don't Vindicate the Supply Siders". Berry used a series of tables to try and show that the primary reason the share of taxes paid by the lower-incomes went down, was their incomes dropped, while those of the rich rose.

The problem is Berry's long and tortured analysis turned out to be fatuous. First, as the WALL STREET JOURNAL pointed out (May 7), the primary reason incomes under 25,000 fell in 1982 was that there were 2.5-million fewer taxpayers in this group. A like number moved to higher brackets due to inflation. On a per- taxpayer basis, incomes rose, not fell, as Berry stated.

Second, if Berry had bothered to study the IRS release, he would have found that another reason for the lower Adjusted Gross Income (AGI) figures was "a sharp increase in the amount of income placed into individual retirement arrangements (IRAs) and the introduction of the two-earner married couple deduction..."

In other words, much of the Reagan tax cut was "off the top," reducing the income taxed, especially among the low- to medium-income earners. As the IRS report stated, "total payments to [IRAs] increased by 492 percent [from $4.7 billion] to $28.4 billion." This means IRAs alone accounted for nearly $24 billion in lower income being reported in the AGI figure, more than enough by itself to account for the POST's mistake.

What is most troubling is that, through sources, we have learned that Berry's badly flawed analysis was leaked to him by a staff member of the Treasury's Office of Tax Analysis at the instigation of David Stockman's Office of Management and Budget (OMB).

Their urgency in doing this was tipped off in Berry's line, "Some administration officials were urging that President Reagan cite the [IRS] number in a forthcoming speech as evidence that his tax cuts were working exactly as promised...."

In other words, the OMB's anti-supply-side insiders were determined not to let the president make that "mistake.' Unfortunately, their own analysis used by the POST was "mistaken."

Within ten days, the prestigious American Institute of Economic Research weighed in with its analysis in the WALL STREET JOURNAL showing that, on an individual tax-return basis, the 1982 tax cut was actually 25- to 40-percent more favorable to low-income groups than the Congressional Budget Office (and OMB) had predicted, and 74-percent LESS favorable to the rich. For example, where CBO had estimated (as recently as April 3) that the 1982 tax cut provided an average reduction of $5,100 to the average over-$80,000 income-earner, the actual figure in 1982 for this group was only $1,210. Why?

"The data strongly suggest that the 'rich' chose to show more income to the IRS in 1982, a supply-side response to the Reagan tax cuts." Just as Arthur Laffer had forecast, lower rates produced higher taxpaying by the rich.

But the most important rebuttal to the WASHINGTON POST and its administration shills was an analysis by two former JEC economists, Lowell Gallaway and Richard Vedder of Ohio University, provided to this column recently (see Table). This analysis wipes out all of the distortions caused by inflation, recession, and bracket creep, and simply applies an income percentile basis to compare the 1981 and 1982 income groups.

It shows that in 1982, the tax share paid by the nation's top 1 percent (incomes over $80,000) rose 14.1 percent, while that paid by the bottom 20 percent (incomes below $9,000) declined 12 percent, and the bottom 40 percent dropped by 9 percent. A classic "progressive re-distribution."

Taxes paid by the top 1 percent rose $6 billion, while taxes paid by the bottom 40 percent dropped $1.9 billion. This means during the first year of the Reagan tax cut -- the year when the rich got the biggest percentage cut, the actual tax distribution got substantially more "progressive."

Economists have a term for this called the Gini Coefficient that measures the degree of difference from top to bottom in any distribution curve. In 1982 that Gini Coefficient rose from .573 to .587, a substantial 3.3-percent rise in "progressivity."

So, the "fairness" assault on the Reagan tax cut is merely an old-fashioned, left-wing lie (see Table below).

Distributed by Heritage Features Syndicate

The Income Tax Burden 1981-82

	% of Tax Paid 1981	1982	% Shift of Tax Burden	$ Shift of Tax Burden (Millions $)
Top 1 Percent	15.58%	17.77%	+ 14.1%	$ + 6,825
Top 5 Percent	31.82%	33.07%	+ 4.0%	+ 3,439
Top 40 Percent	80.10%	81.07%	+ 1.2%	+ 1,981
Bottom 60 Percent	19.90%	18.93%	- 4.9%	- 2,667
Bottom 40 Percent	7.91%	7.23%	- 8.6%	- 1,870
Bottom 20 Percent	1.97%	1.73%	-12.2%	- 660
Gini Coefficient (progressivity) For Tax Distribution	.57303	.58698	+ 3.27%	-

Source: IRS Preliminary Income Tax Stats
For 1982 Returns
Analyzed by Gallaway and
Vedder---Ohio University.

Senator **Jepsen**. Mr. Gwartney, welcome. Your statement as written will be entered into the record. You may proceed as you so desire.

STATEMENT OF JAMES GWARTNEY, PROFESSOR, FLORIDA STATE UNIVERSITY

Mr. **Gwartney**. Thank you, Mr. Chairman. I appreciate the opportunity to appear before this distinguished panel and I would like to focus on one aspect of the implications of the proportional tax reduction; that is, one that cuts rates across the board, that I think is oftentimes overlooked.

The 1981 Economic Recovery Tax Act was a modest effort to reduce the negative side effects of high marginal tax rates and, except for the imposition of the 50-percent rate ceiling, ERTA provided for proportional rate reductions. So it's very important to look and see what the incentive implications of that are.

Tax rates in all brackets were cut by approximately 23 percent over 4 tax years. Some observers have a great deal of difficulty understanding that a proportional rate reduction, one that cuts each rate by the same percentage, will shift the burden of the income tax to the upper income brackets. Yet this is precisely what both economic theory and the experience of our rate reductions indicate. Contrary to the assumption of many, taxable income is not in variant to changes in the tax rates. This is where so many people go wrong in analyzing the distributional consequences. When tax rates decline, the take-home pay per dollar of additional earnings will increase and from an incentive standpoint, what is really important is the impact that tax rate changes have on take-home pay.

After all, people work, save, and invest mainly for after-tax income. The larger the share of additional earnings the taxpayer is permitted to keep, the greater his or her incentive to generate additional income. The incentive effect of a proportional tax reduction will differ considerably across tax brackets. This is important in understanding the distribution of income.

Proportional rate reductions, such as the 1963–65 reductions and the 1981–83 reductions, all increase take-home pay derived from additional earnings far more in the upper brackets than in the lower brackets.

Perhaps some numbers will drive this point home. Suppose tax rates are cut across the board by, say, 20 percent. In the 10-percent marginal tax brackets, the 10-percent rate is cut to 8 percent and this would increase take-home pay from 90 cents to 92 cents. Now even though I believe incentive matter, I expect this is going to have a less than dramatic impact on the tax base or the incentive of individuals in the very low tax bracket to earn additional reported taxable income or to reduce their incentive to engage in tax shelter activity.

On the other hand, consider what happens at the top rates. The same 20-percent rate at the top of the income spectrum will increase the take-home pay at the 70-percent rate from 30 cents per dollar of additional earnings to 44 cents per dollar of additional earnings. In other words, you cut the 70-percent rate by a proportion of 20 percent and it would reduce it to 56 percent. This would mean after-tax earnings would increase from 30 cents on the dollar to 44 cents on the dollar.

So what happens in the upper tax brackets, the same proportional rate reduction leads to a larger increase in the tax base in the upper marginal rate.

Now why this is important is the impact upon the revenue gain will be directly proportional to that tax base. The largest increase in revenues or smallest reduction in revenues will come in those areas where the tax base increases the most. So theory says that you would expect the tax base to be increased most in the upper brackets. Therefore, this proportional tax reduction predictably will expand the income base more in the upper brackets—taxable income base now—and will lead to an increase in the amount of revenues obtained from those upper income brackets relative to lower income brackets.

In other words, it will shift the burden of the income tax to the upper income brackets.

Well, the test of a theory is, of course, in the evidence. When we look at the evidence for the two most recent major proportional rate reductions of 1963 and 1965, for example, in 1963–65, plus the 1981–82 data, my exhibit 5 in the prepared statement presents the data organized by income groupings, by percentile groupings, and it looks at the amount of tax liability that each group bore in 1981 and then in 1982.

For example, the bottom 50 percent of taxpayers in 1981 paid $21.7 billion income tax liability. In 1982, that liability fell to $19.5 billion, a reduction of 10 percent. Now at the other end of the spectrum, the top 1.36 percent—this is the group that was most directly affected by the imposition of the 50-percent tax ceiling—in 1981, they paid $58 billion and in 1982 they paid $60.5 billion, an increase of 4.3 percent tax revenues collected from that group.

You will note the two intermediate groups, the 50 to 75 percentile and the 75 to 98.6 percentile, had smaller—as you moved up the income spectrum, reductions in tax revenues and as you move down the income spectrum, of course, the tax revenues reductions were larger.

So what that data indicates is perfectly consistent with the theory. In 1981, the bottom 50 percent paid 7.6 percent of the tax liability. In 1982, they paid only 7 percent of the tax liability. At the top end of the spectrum, the top 1.36 percent of taxpayers paid 20.4 percent of the tax liability. In 1982, that increased to 21.8 percent.

So just as our theory would predict, the largest increases in tax revenues or the smallest reductions were directly proportional to income.

Now that exact same pattern was present in 1963–65. 1981–82 was not an isolated case, as exhibit 6 shows that once again you found that the largest reduction in tax revenues were in the bottom 50 percent of income recipients while you had an increase in the percent of tax revenues gathered from the top 5 percent of taxpayers.

So the data are perfectly consistent with the theory. In addition, to test that hypothesis in a little bit more detail, Prof. James Long of Auburn University and I looked at the 1979 tax data in detail and we attemped to estimate how responsive the tax base was to changes in the rates where what was giving us the change in rates or differences in rates was differences in the State income tax. We superimposed State income tax structures so that you would have an individual in a high tax State—State income tax now, such as Minnesota or New York, where that individual would be facing higher marginal tax rates than an individual with the same income in Texas or Florida, and that would permit us to estimate how that increase in the marginal tax rate affected the tax base.

What we found is, again, what theory would predict, that in the upper income brackets, the rate differentials exerted the greatest impact upon the responsiveness of the tax base, that higher tax rates led to a shrinkage in the tax base and it was particularly important in the upper tax brackets.

So in conclusion, what the analysis of both the major tax cuts—the 1964 tax cut, the 1981 tax cut, as well as the static analysis for a single year where you look at rate differentials—is that the base is more responsive to changes in the rates in the upper income brackets, and the implication is that the proportional rate reduction, far from what has often been put forth in the media and other sources, will actually shift the tax burden to high income people rather than away from high income people, as has often been alleged.

So that my analysis indicates that the 1981 legislation resulted in an increased share of tax revenues paid by the upper income groupings.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Gwartney follows:]

PREPARED STATEMENT OF JAMES GWARTNEY

EXECUTIVE SUMMARY

Many observers are misled as to the distributional effects of a change in tax rates because they erroneously assume that taxable income is unaffected by tax rates. When tax rates decline, particularly high tax rates, people will respond by spending more time earning taxable income and less time (and money) with investment consultants and tax experts figuring out how to shelter their income. As a result, lower rates will expand the tax base. This factor is particularly important in the upper tax brackets.

Once allowance is made for the responsiveness of the tax base to the lower rates, comparison of the 1981 and 1982 tax data indicate that the rate reductions shifted the burden of the income tax toward high income taxpayers. Even though the 50 percent rate ceiling imposed in 1982 cut the rates of high income taxpayers by as much as 28.6 percent (from 70 percent to 50 percent), the tax revenues collected from the wealthy grew. The revenues collected from the top 1.36 percent of taxpayers, the group most directly affected by the sharply lower rates, jumped from $58.0 billion in 1981 to $60.5 billion in 1982. The top 1.36 percent of taxpayers shouldered 21.8 percent of the tax burden in 1982, up from 20.4 percent in 1981 (see Exhibits 4 and 5).

At the other end of the income spectrum, the tax liability fell. The bottom 50 percent of income recipients paid income taxes of $19.5 billion in 1982, down from $21.7 billion in 1981. The share of total income tax revenues contributed by the lower half of income recipients fell from 7.6 percent in 1981 to 7.0 percent in 1982 (see Exhibit 5). Far from creating a windfall gain for the rich, as some have charged, the 1981 tax cut actually shifted the burden of the income tax toward those with higher incomes, including taxpayers who received substantial rate reductions as the result of the 50 percent rate ceiling applicable in 1982.

There is nothing mysterious about the shift in tax liability emanating from the 1981 tax cut. It was totally predictable. The shift in the tax liability toward the rich reflects the greater responsiveness of the tax base to rate changes in the upper brackets. As a result, a roughly proportional rate reduction will always shift the tax burden toward the upper tax brackets. Both the Kennedy-Johnson tax cuts of 1963-1965 (see Exhibit 6) and the rate reductions of the 1980s illustrate this point.

Tax Rates, Taxable Income, and the Distributional Effects of the Economic Recovery Act of 1981

by

James Gwartney*

Contrary to the conventional wisdom, it is not easy to determine the impact of tax rate reductions on the distribution of the tax burden across income groupings. Economic theory indicates that the taxable income base will be negatively related to tax rates, particularly in the upper income brackets. Failure to incorporate the impact of the rate changes on the taxable income base will result in potentially misleading projections. This is precisely the problem with static income projections. They are based on the fallacious assumption that taxable income is unaffected by changes in tax rates.

This study integrates the impact of the rate changes on the taxable income base when estimating revenue changes across income groupings. Comparative income and revenue data for 1981 and 1982 are utilized to analyze the distributional effects of the Economic Recovery Tax Act of 1981 (ERTA). The findings are discussed in light of both economic theory and other research in this area.

Tax Facts and Tax Policy

Historical evidence sheds light on the likely distributional effects of ERTA. The following four tax policy facts will help the reader better understand the forces at work.

---

*Dr. Gwartney is a Professor of Economics and Policy Sciences at Florida State University and Research Associate for the Political Economy Research Center.

Fact 1: Literally millions of Americans now pay marginal tax rates that were previously reserved for only the rich and super rich. During the last two decades, inflation and the accompanying bracket creep brought high marginal tax rates to the moderately successful American family. Exhibit 1 illustrates this point. In 1965, only 2.9 percent of the families (1.13 million returns) filing joint returns confronted a marginal federal income tax rate of 28 percent or more. By 1979, the figure had jumped to 35.3 percent (15.238 million returns), a twelvefold increase over the 1965 figure. Stated another way, by the end of the 1970s most persons in the upper third of the income distribution faced marginal tax rates previously confronted by only the very rich--the top 2 or 3 percent of earners. As Exhibit 1 shows, the picture is the same for still higher marginal tax rates. While only 1.0 percent (376 thousand) of the taxpayers filing joint returns in 1965 paid a marginal rate of 37 percent or more, the comparable figure in 1979 was 12.8 percent (5.533 million returns). A similar increase was recorded in the 49 percent marginal tax bracket.

These figures, as dramatic as they are, actually understate the increases in marginal tax rates during the last two decades. In the mid-1960s, persons facing marginal rates of 30 percent or more would have had earnings above the cutoff point of the Social Security payroll tax. This would not be true today. For most taxpayers in the 30 percent federal income tax range, the Social Security tax boosts their effective marginal rates another 6.7 percent. If they live in states with an income tax, this tax takes another 5 or 10 percent of their additional earnings.

Exhibit 1: The Rising Marginal Federal Income Tax Rates: 1965-1979

	1965	1970	1973	1977	1979
No. of Joint Returns (in millions)	39.506	42.660	39.805	42.576	43.217
Joint Returns (in millions) Facing:					
Marginal Tax Rates of 28 percent or more	1.130	2.984	5.386	12.003	15.238
(percent)	2.9%	7.0%	13.5%	28.2%	35.3%
Marginal Tax Rates of 32 percent or more	.722	1.701	3.044	7.308	9.782
(percent)	1.8%	4.0%	7.6%	17.2%	22.6%
Marginal Tax Rates of 37 percent or more	.376	.797	1.321	2.965	5.533
(percent)	1.0%	1.9%	3.3%	7.0%	12.8%
Marginal Tax Rates of 49 percent or more	.136	.296	.481	1.032	1.541
(percent)	0.3%	0.7%	1.2%	2.4%	3.6%

Source: Internal Revenue Service, *Statistics of Income: Individual Income Tax Returns* (Annual).

Clearly, the tax collectors take 40 percent or more of each additional dollar earned by many middle and upper middle income families--particularly those with dual earners.

Fact 2: As marginal tax rates increased during the post-1965 period, tax avoidance activities soared. Sheep may stand still while they are sheared, but taxpayers do not. Predictably, they responded to the higher rates by increasing their tax avoidance activities. Self employment, which offers greater opportunity for tax avoidance, expanded rapidly as the marginal tax rates rose. The underground economy grew at a rate twice that of the "reported income" economy. The prices of depreciable assets, including housing, increased more rapidly than the general price level, as investors sought out projects yielding accounting losses while appreciating in value. Of course, the losses reduced their current tax liability while the appreciation transformed ordinary income into a capital gain.

In several areas, this expansion in tax avoidance is clearly observable. A comparison of income losses relative to gains in major categories affected by tax shelter investments illustrates this point. As Exhibit 2 shows, during the 1966-1981 period, there was a sharp increase in net income losses from rents, business and professional practice, farming, partnerships, and small business corporations, the income categories most directly affected by tax shelter investments. In 1966, net income gains from these five categories were seven times greater ($52.23 billion compared to $7.43 billion) than the net income losses. In each category, net income gains were substantially greater than the

Exhibit 2: Net Income Losses Compared with Net Income Gains for Selected Sources of Income, 1966 and 1981

Source of Income Gain or Loss	1966 Returns Net Income Gain (in billions)	 Net Income Loss (in billions)	 Loss/Gain Ratio (percent)	1981 Return Net Income Gain (in billions)	 Net Income Loss (in billions)	 Loss/Gain Ratio (percent)
Rents	$ 4.36	$1.75	40.1	$ 15.05	$17.82	118.4
Business and Professional Practice	28.14	1.95	6.9	68.53	15.46	22.6
Farming	5.99	1.92	32.0	8.53	16.34	191.6
Partnerships	12.08	1.35	11.2	25.91	26.05	100.5
Small Business Corporations	1.66	.46	27.7	4.26	5.07	119.0
Total	$52.23	$7.43	14.2	$122.28	$80.74	66.0

Source: Internal Revenue Service, Statistics of Income: Individual Income Tax Returns (Annual).

losses. By 1981, the picture had changed dramatically. By 1981, the net income gains were only one and a half times greater ($122.28 billion compared to $80.74 billion) than the losses. In four of the five categories the losses actually exceeded the gains.

Fact 3: High marginal tax rates promote economic waste and discourage productive activities. When individuals bear the full cost of their actions and are able to reap fully the gains that occur from their activities, they use resources wisely. When I bear the full cost of food, clothing, telephone service, recreation facilities and thousands of other items, you can be reasonably sure that I will conserve on my use of these items. I will not consume them unless I value the services that they provide more than the cost of the provision. Similarly, when I am able to reap the full benefits of my productive activities, you can be sure that I will undertake even unpleasant tasks when the benefits (usually personal income) exceed the costs. When individuals bear the full cost and reap the full benefits, they will use resources in a wealth-creating manner. They will engage in positive-sum economic activity.

In contrast, as economists have long been aware, problems arise when a sizable share of the benefits or costs emanating from economic activity accrues to non-participating parties. This is precisely the problem that arises when marginal tax rates are high. High maginal tax rates make it possible for individuals to enjoy tax deductible items at a fraction of their costs to our economy. High marginal tax rates make tax deductible expenditures cheap to the taxpayer-consumer, but not to society. The personal cost of tax-reducing expenditures such as business-related vacations, luxury restaurants, nice automobiles, plush offices, mortgage financed homes and literally thousands of other items are substantially reduced because such items are deductible. However, deductibility does not reduce the cost to society of the valuable resources used to produce these commodities. Since they bear only a fraction of the costs, individuals often choose the deductible goods and services even though the items cost more to produce than they are valued by the taxpayer-consumer. Wealth is destroyed by this process; it wastes our valuable resources.

Simultaneously, high marginal tax reduce the incentive of individuals to engage in wealth-creating activities that generate taxable income. When taxpayers are permitted to keep only 40 or 50 percent of the fruits of their labor, they spend less time working in the taxable income garden. Lawyers, doctors and other high income professionals spend more time on the golf course and consulting with their accountants and less time serving their clients. Similarly, secondary workers decide that their job is not worth the hassle when they get to keep only a fraction of every dollar they earn. Individuals forego wealth-creating activities because they are unable to capture fully the fruits of their labor. The result--a smaller output and slower economic growth.

It is no coincidence that the 1970s were a period of both rising marginal tax rates and stagnating economic growth. The incentive structure created by the former leads to the latter.

Rising marginal tax rates and stagnating economic growth--predictably, the two will be associated.

Fact 4: Essentially what the Economy Recovery Tax Act of 1981 (ERTA) did was correct for bracket creep and higher Social Security tax rates. Except for the imposition of the 50 pecent rate ceiling which took effect in 1982, ERTA did little to rollback high marginal tax rates. In a nutshell, it kept rates from increasing. Exhibit 3 indicates the marginal tax rate a two-earner family of four would confront if their money income just kept pace with inflation. Thus, their inflation adjusted family income is constant. Only the federal income and Social Security taxes are considered. The data indicate that by 1984, marginal tax rates are slightly lower then 1980, but almost identical to the marginal rates of 1979 for families with real incomes (1979 dollars) of less than $75,000. Since returns with an adjusted gross income of $75,000 or less constitute approximately 98.5 percent of the total, it is clear that ERTA only modestly reduced the enormous rate increases that took place during the 1970s.

The Incentive Effects of a Proportional Rate Reduction Differ Across Tax Brackets

Many observers are misled as to the distributional effects of a change in tax rates because they erroneously assume that taxable income is unaffected by tax rates. Static revenue comparisons based on the assumption that taxable would be the same before and after the rate changes is a meaningless exercise. They are akin to General Motors comparing before and after revenues associated with, for example, 10 percent price reduction, assuming that the number of GM automobiles purchased by consumers remained

Exhibit 3: Marginal Tax Rates for a Two-Earner Family of Four, 1979-1984[a]

Adjusted Gross Income (1979 Dollars)	Marginal Tax Rate[a] (percent) 1979	1980	1982	1984
20,000	24.13	27.13	28.7	24.7
40,000	38.13	43.13	45.7	39.7
60,000	49.13	55.13	50.7	48.7
75,000	49.00	54.00	49.0	48.7
100,000	54.00	54.00	50.0	45.0

[a] The data are for federal personal income and social security tax liabilities. The calculations are based on the following assumptions: The couple files a joint return and all income is earned income. The second wage earner earns one-half the amount of the first. Taxpayers take the zero-bracket amount or itemize deductions equal to 23 percent of income, whichever is greater. When calculating the 1980 and 1984 incomes in 1979 dollars, the actual inflation rates were used for the 1980-1983 period and a 5 percent inflation rate was projected for 1984.

constant. However, since consumers would buy more GM cars at the lower price, such a calculation would be of little value to a manager seeking to determine the impact of a price reduction on GM revenues. Similarly, since taxpayers will generate more taxable income at the lower rates, the static projects reveal little about the impact of the lower rates on tax revenues.

As Richard Stroup and I discussed in an article on the 1964 tax cut, economic theory provides insight on the distributional effects of a proportional tax rate reduction.[1] The 1964 tax cut reduced rates across the board by approximately 20 percent. Except for the 50 percent rate ceiling, ERTA also reduced rates proportionally. By 1984, both upper and lower rates applicable to nominal income were approximately 23 percent lower, as compared to the 1980 rates.

When tax rates fall, particularly high tax rates, people will respond to the lower rates by spending more time earning taxable income and less time (and money) with investment consultants and tax experts figuring out how to shelter their income. The result--the tax base expands due to the lower rates. Higher rates exert the opposite effect. For an economist, the negative relationship between tax rates and the size of the tax base should be obvious. After all, it is merely a reflection of the basic economic postulate that "incentives matter" in a predictable way.

From an incentive standpoint, what really matters is the impact of a tax rate change on after-tax income. People work, save, and invest mainly for "take home" income. The larger the share of additional earnings that the taxpayer is permitted to keep, the greater his or her incentive to generate additional income.

---

[1] James Gwartney and Richard Stroup, "Tax Cuts: Who Shoulders the Burden," Economic Review: Federal Reserve Bank of Atlanta, March 1982.

The incentive effects of a proportional tax reduction will differ considerably across tax brackets. Proportional rate reductions, such as the 1963-65 and 1981-83 tax cuts, will increase the take-home pay derived from additional earnings far more in the upper brackets than for the lower brackets. Perhaps some numbers will drive this point home. Suppose tax rates are cut across the board by 20 percent. In the 10 percent bracket, the rate is cut to 8 percent. For the 50 percent bracket, the rate falls to 40 percent and the 70 percent rate declines to 56 percent. Now, consider how this proportional rate reduction impacts take-home pay. For persons in the 10 percent bracket, after-tax income increases from 90 cents per dollar of additional earnings to 92 cents, a paltry 2.2 percent increase. Clearly this small increase is unlikely to exert a major impact on the incentive of those taxpayers to earn more taxable income. In contrast, look what happens in the 70 percent bracket. Here the 20 percent rate reduction increases take-home pay from 30 cents to 44 cents per dollar of additional earnings--an increase of 47 percent. This exerts a substantial incentive effect. Taxpayers in this and other high income brackets are now permitted to keep a significantly larger proportion of their before tax earnings. Predictably, they will respond by earning more taxable income and engaging less intensely in tax shelter activities which generate less tax savings at the lower rates.

How does this incentive structure affect the distribution of the tax burden across income groupings? The answer is now straightforward. Since the rates were all reduced by the same percentage, the size of the revenue reduction will be inversely related to the changes in taxable income. If taxable income is virtually unaffected by the rate reductions, as is likely to be the case in the lowest marginal tax brackets, revenues will fall by the same percent as the rates. In these brackets, a 20 percent rate cut will lead to approximately a 20 percent reduction in tax revenues. In contrast, in the upper income (and marginal tax) brackets where the incentive effects on take-home pay are greater, increases in the tax base will at least partially offset the lower rates. In these brackets, tax revenues will fall by less than the 20 percent rate reduction.

Since tax revenues fall by a smaller amount in the upper income brackets, the share of taxes collected from high income taxpayers expands. As the Laffer curve emphasizes, if the expansion in the revenue base in the upper brackets is large enough, lower rates may lead to an increase in revenues. However, even if this is not the case, the incentive structure indicates that the tax burden is shifted toward the rich.

The Distributional Effects of ERTA

Thus, economic theory indicates a proportional rate reduction will shift the tax burden to high income taxpayers because the taxable income base will be more sensitive to rate changes in the upper tax brackets. However, the 50 percent tax ceiling reduced the highest tax rates (on non-personal service income) more than proportionally. Unless the tax base is highly responsive in the upper brackets, the 50 percent ceiling may reduce the share of revenues collected from taxpayers previously facing marginal rates of 50 percent or more. The test of a theory is in its ability to predict. We now turn to the empirical evidence.

Exhibit 4 presents income and revenue data for taxpayers most directly affected by the imposition of the 50 pecent rate ceiling. In recent years, itemized deductions have averaged slightly more than 20 percent of adjusted gross income (AGI). Assuming itemized deductions summed to 20 percent of AGI, taxpayers filing joint returns with adjusted gross incomes in excess of $75,000 would have confronted marginal tax rates of more than 50 percent in 1981. The 50 percent rate ceiling would have reduced the marginal rates of similarly situated taxpayers in 1982. The rates (on non-personal service income) of those at the top of the income pyramid were slashed from 70 percent to 50 percent, a whopping 28.6 percent cut in one year. Thus, in this area the rate reductions in 1982 were both real and significant.

In 1981, 1.36 percent of the returns had gross incomes of $75,000 more. Exhibit 4 compares the income and tax liability of the top 1.36 percent of tax returns in 1981 with the parallel data for 1982. Just as our theory indicated, the reported adjusted gross income, wages and salaries, and taxable income of this group of taxpayers grew quite rapidly. Even though 1982 was a recession year and nominal gross national product rose by only 4 percent,

Exhibit 4: The Estimated Growth Rate of Income Components and the Income Tax Liability for Taxpayers Affected by the 50 Percent Tax Ceiling of ERTA Compared to Other Taxpayers

	Top 1.36 Percent of Tax Returns[a]			Bottom 98.64 Percent of Tax Returns		
	1981	1982	Percent Change	1981	1982	Percent Change
No. of Returns (in millions)	1.3005	1.2992	- 0.1	94.096	93.998	-0.1
Income Range	>$75,000	>$80,300	—	<$75,000	<$80,300	—
Adjusted Gross Income (billions)	$177.0	$196.9	+11.2	$1595.6	$1652.3	+3.6
Wages and Salaries (in billions)	$102.3	$113.0	+10.5	$1383.8	$1451.6	+4.9
Taxable Income (in billions)	$138.2	$155.0	+12.2	$1245.5	$1313.9	+5.5
Income Tax Liability (in billions)	$ 58.0	$ 60.5	+ 4.3	$ 226.1	$ 216.4	-4.3

[a] In 1981, persons filing joint returns faced a marginal tax rate of more than 50 percent on non-service income if their taxable income was in excess of $60,000. Allowing for 20 percent itemized deductions, this suggests that returns with an AGI of $75,000 or more would have confronted marginal rates in excess of 50 percent in 1981. In 1981, 1.36 percent of all returns had an adjusted gross income of $75,000 or more. Here, the income and tax liability of the top 1.36 percent of returns (those confronting a marginal tax rate of 50 percent or more in 1981) are compared with the income and tax liability data for the top 1.36 percent of returns in 1982.

Source: The 1981 data are from Internal Revenue Service, 1981 Statistics of Income: Individual Income Tax Returns, Tables 1.1 and 1.3. The 1982 data are from Internal Revenue Service, Statistics of Income: SOI Bulletin (Winter 1983-84), pp. 11-22.

AGI, wages and salaries, and taxable income for the top 1.36 percent of taxpayers, each expanded at double digit rates. As a result of the rapid growth of taxable income, the tax revenues collected from the top 1.36 percent of taxpayers rose from $58.0 billion in 1981 to $60.5 in 1982, a 4.3 percent increase in a recession year. These findings illustrate that the taxable income base is quite sensitive to changes in the rates, at least in the upper tax brackets.

Exhibit 4 also presents the income and revenue data for all other taxpayers (the bottom 98.64 percent). As expected, the reported income of other taxpayers grew less rapidly, more in line with the growth rate of GNP. As a result, the tax liability of the bottom 98.64 percent of taxpayers, reflecting the lower rates in 1982, declined by 4.3 percent. Thus, even though the 50 percent ceiling cut the top rates by a larger amount, tax revenues collected from the taxpayers most directly affected by the rate ceiling expanded by 4.3 percent while the tax liability of other taxpayers declined by an identical percentage.

Exhibit 5 presents data on the share of tax revenues collected from a broader set of income groupings for both 1981 and 1982. The tax liability of the bottom 50 percent of returns fell from $21.7 billion in 1981 to $19.5 billion in 1982. In these lower tax brackets, the 10 percent lower rates resulted in approximately 10 percent less tax revenues. Thus, the bottom 50 percent of returns contributed only 7.0 percent of the tax revenues in 1982, down from 7.6 percent in 1981. The tax liability of taxpayers in (a) the 50 to 75 percentile and (b) the 75 to 98.64 percentile

Exhibit 5: The Share of Tax Revenue Collected from Various Percentile Groupings Ranked According to Adjusted Gross Income--1981 versus 1982

	Income Tax Liability (billions)			Share of Total Income Tax Liability	
	1981	1982	Percent Change	1981	1982
Bottom 50 percent[a]	$ 21.7	$ 19.5	-10.1	7.6	7.0
50 to 75 percentile[a]	$ 59.0	$ 55.6	- 5.8	20.8	20.1
75 to 98.64 percentile[a]	$145.4	$141.3	- 2.8	51.2	51.0
Top 1.36 percent[a]	$ 58.0	$ 60.5	+ 4.3	20.4	21.8
Total	$284.1	$276.9	- 2.5	100.0	100.0

[a] The adjusted gross income intervals for the percentile groups were:

	1981	1982
Bottom 50 percent	<$14,160	<$14,344
50 to 75 percentile	$14,160-$26,140	$14,344-$26,855
75 to 98.64 percentile	$26,140-$75,000	$26,855-$80,300
Top 1.36 percent	>$75,000	>$80,300

When necessary, interpolation was used to estimate the tax revenues within income intervals.

Source: The 1981 data are from Internal Revenue Service, 1981 Statistics of Income: Individual Income Tax Returns, Tables 1.1 and 1.3 The 1982 data are from Internal Revenue Service, Statistics of Income: SOI Bulletin (Winter 1983-84), pp. 11-22.

groupings also declined by 5.8 percent and 2.8 percent respectively. Thus, the share of income tax revenues paid by these groups declined slightly. In contrast, the share of income taxes paid by the top 1.36 percent rose from 20.4 percent in 1981 to 21.8 percent in 1982. Note the decline in tax liability was inversely related to income--the largest reductions in tax liability were in the lowest income and marginal tax brackets. As economic theory indicates, this is precisely the pattern that one would expect from a roughly proportional rate reduction. Far from creating a windfall gain for the rich, as some have charged, ERTA actually shifted the burden of the income tax toward taxpayers in upper brackets, including those who received the largest rate reductions as the result of the 50 percent rate ceiling.

Exhibit 6 presents parallel data for the 1964 tax cut. Just as theory predicts, the proportional rate reductions of 1964-65 also shifted the tax burden to the rich. The tax revenues collected from the bottom 50 percent of returns fell by 6.4 percent between 1963 and 1965. Smaller reductions in tax liability accrued to those in the 50 to 75 percentile and 75 to 95 percentile groupings. In contrast, the revenues collected from the top 5 percent of returns rose by 16.9 percent between 1963 and 1965. As a result, the share of tax revenues collected from the top 5 percent of taxpayers rose from 35.6 percent in 1963 to 38.5 percent in 1965. The proportion of revenues collected from all other groups fell. Just as economic theory predicts, the proportional rate

Exhibit 6: The Share of Tax Revenue Collected from Various Percentile Groupings Ranked According to Adjusted Gross Income Prior to and Subsequent to the 1964 Reduction in Tax Rates

	Tax Revenues Collected from Group (in billions)			Percent of Personal Income Taxes Collected from Group[a]	
	1963	1965	Percent Change	1963	1965
Bottom 50 percent	$ 5.01	$ 4.69	- 6.4	10.4	9.5
50 to 75 percentile	10.02	9.90	- 1.2	20.8	20.0
75 to 95 percentile	16.00	15.88	- 0.7	33.2	32.1
Top 5 percent	17.17	19.05	+10.9	35.6	38.5
Total	$48.20	$49.53	+ 2.8	100.0	100.0

[a] These estimates were derived via interpolation.

Source: Internal Revenue Service, Statistics of Income: Individual Income Tax Returns (1963 and 1965).

reductions of 1963-1965 like the reductions in 1981-1982 shifted the tax burden to the rich.

Two Fallacious Views As To Why High Income Taxpayers Paid More Taxes in 1982

Confronted with the evidence that the tax burden shifted toward upper income taxpayers in 1982, critics of the "incentives matter" view have raised two points. First, some have argued that the pattern merely reflects cyclical conditions--the recession of 1982. Of course, a recession does reduce incomes. However, there is no reason to believe that it reduces incomes more in lower tax brackets than in upper brackets. In fact, the evidence indicates that the business income and profits fluctuate more than other components of income over the business cycle. This being the case, a recession is more likely to retard incomes in the upper tax brackets more severely than in the lower brackets because business income and profits are a larger component of total income for those with higher incomes. However, the most damaging evidence against the cyclical view is the pattern of the 1963-1965 data. During this period of economic growth and rising incomes, the distributional pattern emanating from a tax reduction was similar to the pattern experienced in 1982. This indicates that changes in the structure of incentives across tax brackets is far more important than cyclical conditions as a determinant of changes in tax liability across income groupings.

Second, other critics have argued that the shift in the tax burden toward the rich merely reflects rising capital gains associated with the bull market on Wall Street beginning in August 1982. Inspection reveals that this is a "tail wags dog" theory.

Capital gains are a small component of total income. In 1981, net capital gains less losses contributed only 1.7 percent to the total adjusted gross income. Even for the top 1.36 percent of taxpayers, the capital gains component was only 9.6 percent of AGI. Given the size of capital gains as a share of AGI, it would have taken a huge expansion in capital gains income to explain the observed pattern of income growth across income groupings in 1982. But the actual increase in net capital gains income was rather modest--from $29.3 bilion in 1981 to $32.0 billion in 1982, an increase of only 9.2 percent. Of course, the major component of income is wages and salaries. In 1981, the wage and salary component summed to 84 percent of AGI. As Exhibit 4 shows, this component of income grew substantially more rapidly in the upper tax brackets between 1981 and 1982. Clearly, it provided the major impetus for the growth of taxable income in the upper brackets.

Why Taxpayers Have Not Made a Major Move Out of Tax Shelters

As we noted previously, the tax shelter industry boomed with the rising marginal tax rates of the 1970s. In fact, taxpayers are still adjusting their investment portfolios to the higher marginal rates. We are in the midst of a tax shelter investment boom. Why didn't the 1981-1984 tax cuts arrest the growth of the tax shelter industry?

There are three major reasons why recent tax changes have failed to reduce significantly the size of the tax shelter industry. First, given bracket creep and higher Social Security tax rates, marginal tax rates are not much lower today than they were in 1979 and 1980 for taxpayers with an AGI of less than $75,000 (see Exhibit 3). Since the overall marginal rates were not reduced, at least not reduced very much, it is not surprising that there has been little movement away from tax shelters.

Second, ERTA provided far more rapid depreciation allowances beginning in 1982. This aspect of the legislation would make tax shelters more attractive. The more rapid depreciation write-off would mean larger up front losses from real estate and other depreciable investments. Far from discouraging the tax shelter industry, the rapid depreciation allowances made the shelter business more profitable.[2]

Finally, the incentive to engage in tax shelter investments is influenced by expected future rates as well as current rates. Many influential policymakers have argued, and continue to argue, that tax rates will have to be increased in the near future.

---

[2] Some of us indicated at the time the legislation was passed, that this would be the case. For example, Richard Stroup and I stated the following at a conference held in March 1982:

> "Will the Reagan tax program reduce the flow of resources into tax avoidance? Unfortunately, the answer is, 'Probably not.' Congress added sections providing favorable tax treatment for special-interest groups such as racehorse owners and commodity traders. The leasing provision of the new law will increase the attractiveness of this technique as a means of sheltering income. The more rapid depreciation write-offs, particularly for real estate, will clearly increase the attractiveness of tax-shelter investments in depreciable assets.
>
> However, the major reason for doubting that the 1981 legislation will reduce tax avoidance is that for most people it does not reduce marginal tax rates on real income. The rates during 1981-84 will be lower than they would have been in the absence of the Reagan plan. However, they will be about the same or higher than the 1980 tax rates."

See Federal Reserve Bank of Atlanta, Supply-side Economics in the 1980s (Westport, Conn.: Quorum Books, 1982).

Given the current environment, many investors anticipate higher tax rates in 1985 and 1986. Predictably, they will stay with their tax shelter investments, so they will not be caught short when the anticipated higher rates are instituted.

Additional Evidence from the 1979 Data

Analysis of both the 1963-1965 and 1981-1982 data indicate that the taxable income base is more responsive to rate changes in the upper income (and tax rate) brackets. In the terminology of economists, the tax elasticity coefficient is larger in the upper income brackets. In order to investigate this issue more thoroughly, Professor James Long of Auburn University and I utilized the Internal Revenue Service 1979 Individual Tax Model File to estimate the impact of differences in marginal tax rates on the taxable income base. Since the IRS data contain a state of residence indicator, we were able to integrate the federal and state rate structures so the income base of persons with the same gross income but a different effective marginal tax rate (reflecting differences in the state marginal tax rates) could be compared.

Seeking to obtain an income measure that was not contaminated by tax sheltering, we developed a gross income variable. "Gross income" is defined as the positive components of income and thus is a measure of taxpayer income prior to their engaging in tax shelter activities. In contrast, "adjusted gross income," as defined by the IRS, indicates the income of taxpayers after deduction of losses from many, if not most, tax shelter activities.

Thus, gross income is a better indicator of the taxpayer's income level in the absence of tax shelter activity.

Utilizing the 1979 data, the following model was developed and estimated:

Taxable Income = f(MTR, GI, Age, PE, and IA)

where: MTR is the combined marginal federal and state income tax rate the taxpayer would confront in the absence of deductible expenditures and deductions for losses,

GI is the gross income of the tax return,

Age is a dummy variable indicating the taxpayer is age 65 or over,

PE is the number of personal exemptions, and

IA is a dummy variable indicating the taxpayer used the income averaging method to calculate tax liability.

In order to reduce variability from factors outside the focus of our study, only taxpayers filing joint returns were included in our analysis.

Taxpayers residing in states where the state marginal tax rate is higher will confront higher marginal tax rates than taxpayers in states with lower rates. State marginal tax rates range from zero in states without an income tax to maximum rates in the teens in several states.[3] Therefore, even after making allowance for the deductibility of state income tax payments on one's federal return, differences in state income tax rates lead to substantial differences in marginal rates among taxpayers with similar gross income and number of exemptions.

---

[3] Florida, Nevada, South Dakota, Texas, Washington, and Wyoming did not levy a state income tax. In contrast, California, Delaware, Hawaii, Iowa, Minnesota, Montana, New York, and Wisconsin all levied maximum rates of 11 percent or more in 1979.

Within the framework of our model we are most interested in the impact of changes in marginal tax rates on taxable income. Since higher marginal rates increase the taxpayer's incentive to shelter income and thereby reduce taxable income,[4] we expect a negative relationship between taxable income and marginal tax rates. The regression equations for our model were estimated within income groupings. Exhibit 7 summarizes the results. As expected, higher marginal tax rates exerted a negative impact on taxable income for all income categories except the $20,000 to $40,000 grouping where the estimated coefficient was zero. Predictably, the largest negative impact was in the high income (and high marginal tax rate) categories. For the $40,000 to $60,000 gross income cell, after adjusting from gross income, age, personal exemptions, and income averaging, taxable income declined by $103 for every one unit increase in marginal tax rates. This indicates that in this income range, a one unit increase in the marginal tax rate induces a decline of $103 in taxable income. For the $60,000 to $80,000 gross income grouping, taxable income is estimated to decline by $321 for each one unit increase in marginal tax rates. As one moves to income groupings

---

[4] Since we are interested only in taxpayer decisionmaking that influences their taxable income, our taxable income variable adds state and local income tax deductions to the taxpayers' taxable income. Thus, the lower taxable income for taxpayers confronting high marginal tax rates reflects factors other than the deductibility of state and local income tax liability from their gross income.

Exhibit 7: The Estimated Elasticity of Taxable Income with Respect to Marginal Tax Rates for Various Income Categories - Joint Returns 1979

Gross Income	Impact of One Unit Increase in Marginal Tax on Taxable Income (1)	Estimated Elasticity of Taxable Income with Respect to MTR (2)	Hypothetical Marginal Federal Income Tax Rate, Midpoint of Income Interval, 1979[a] (3)
$ 0- 20,000	-$ 4	- .01	16
20,000- 40,000	0	.00	28
40,000- 60,000	- 103	- .13	43
60,000- 80,000	- 321	- .34	49
80,000-100,000	- 1,525	-1.29	54
100,000-120,000	- 2,584	-1.88	54
120,000-140,000	- 3,371	-2.10	59
140,000-170,000	- 3,629	-1.92	64
170,000-200,000	- 4,999	-2.38	64
over $200,000	- 5,709	-3.93	>64

[a] Assumes a family of four married and filing a joint return. Taxpayers are assumed to take either the standard deduction or itemized deductions equal to 22 percent of AGI, whichever is greatest.

above $80,000, the negative impact of marginal tax rates increases. For the $80,000 to $100,000 gross income cell, the negative impact of a unit tax rate change rose to $1,525. Still, larger estimates were obtained for income brackets above $100,000.[5]

The estimates of Exhibit 7 (column 1) can be converted easily to tax rates elasticities. The tax rate elasticity coefficient is equal to:

$$\frac{\text{percent change in taxable income}}{\text{percent change in marginal tax rate}}$$

Since the tax base and tax rate generally change in opposite directions, a negative tax rate elasticity coefficient is anticipated. If the percent change in the tax base (taxable income in our case) is less than the percent change in the tax rate, the elasticity coefficient will be less than one. Under these circumstances, higher (lower) marginal tax rates would lead to an expansion (contraction) in tax revenues. In contrast, when a change in the tax rate leads to an even larger change in the tax base, the tax rate elasticity coefficient will be greater than one. When this is the case, higher (lower) tax rates would lead to a reduction (increase) in tax revenues. Tax rate elasticity coefficients in excess of unity indicate that taxpayers in the grouping are on the backward bending portion of their Laffer curve.

---

[5] Our estimate for the open-ended $200,000 and above grouping should be interpreted with caution. Since the Internal Revenue Service does not provide information on state of residence for returns with an *adjusted gross income* of $200,000 and over, these returns had to be excluded from our analysis. Thus, we are left with persons who had an *adjusted gross income* of less than $200,000, but a gross income (positive components of income) of more than $200,000. The more tax sheltering undertaken by a taxpayer with an adjusted gross income near the $200,000 cutoff, the more likely their gross income will place them in our $200,000 and over bracket. Therefore, taxpayers in our $200,000 and over gross income grouping may be a bias sample of all returns in this bracket.

Exhibit 7 (column 2) presents estimates for the tax rate elasticity coefficient for each of the ten gross income groupings. For income cells below $60,000, the tax elasticity coefficient is small. However, beginning with the $60,000 to $80,000 gross income cell, the estimated elasticities rise sharply. For gross income cells in excess of $80,000, the estimated tax elasticity coefficient is greater than one. This indicates that lower marginal rates in these cells would have raised more tax revenue.

Perhaps a little additional discussion is necessary to highlight the importance of these estimates. Consider the $60,000 to $80,000 gross income category. Our analysis indicates that taxpayers who have the same gross income (remember gross income is a control variable in the model) report $321 less taxable income for each one unit increase in their effective marginal tax rate. Given the shrinkage in taxable income as tax rates rise in this grouping, it takes a substantial increase in tax rates in order to squeeze additional tax revenue from this tax bracket. In fact, the estimated tax elasticity of minus .34 indicates that a 10 percent increase in tax rates in this bracket will reduce taxable income by 3.4 percent. Thus, the 10 percent higher marginal rates will lead to, at most, only about a 6.6 percent increase in revenues from taxpayers in this bracket.

For higher incomes (and tax rates), the tax elasticity is still greater. For example, the 1.29 estimated tax elasticity in the $80,000 to $100,000 grouping indicates that a 10 percent rate hike in this category would cause a 12.9 percent shrinkage in taxable income. Of course, since the decline in the tax base is larger than the increase in rates, higher rates for this bracket would lead to a reduction in revenue collected. As of 1979, our estimates indicate that taxpayers in this grouping were on the backward bending segment of the Laffer curve. As expected, the estimated elasticities are even larger for the higher income categories.[6]

In interpreting the estimates of Exhibit 7, it is important to recognize that they reflect long-run adjustments. One would expect a smaller shrinkage in the tax base in the year or two immediately following a rate increase than the shrinkage that will eventually take place as the result of a tax rate increase.[7] The major factor contributing to rate differences within income categories in our model is differences in state income tax rates. Since the general pattern of state rates has been in place for a considerable period of time, it is reasonable to assume that taxpayers have adjusted their tax sheltering activities accordingly. Thus, the responsiveness of taxable income to changes in tax rates in the year or two immediately following a change in tax rates may be somewhat less than the magnitude indicated by the estimates of Exhibit 7.

---

[6] Our model estimates the impact of a change in tax rates on taxable income, holding gross income constant. To the extent that higher marginal rates also induce taxpayers to consume more leisure, engage in the underground economy, shift income to closely held corporations, and/or take other steps (e.g., purchase municipal bonds) to reduce their reported gross income, our model will underestimate the negative impact of higher marginal tax rates on the taxable income base.

[7] See James M. Buchanan and Dwight R. Lee, "Politics, Time, and the Laffer Curve," Journal of Political Economy, vol. 90, no. 4 (1982), pp. 816-819.

Summary

Economic theory indicates that the taxable income base will be more responsive to changes in tax rates in the upper tax brackets than in the lower brackets. A detailed analysis of the 1979 individual tax data indicate that this proposition is true. Given the greater responsiveness in the upper brackets, proportional rate reductions such as those instituted in 1964-1965 and 1981-1984 will shift the burden of the income tax to taxpayers in the upper brackets. Predictably, there will be an increase in the share of tax revenues collected in the upper income brackets. The empirical evidence from both the 1963-1965 and the 1981-1982 period is highly consistent with the underlying economic theory.

Senator JEPSEN. Thank you, Mr. Gwartney.

Mr. Richard Rahn, U.S. Chamber of Commerce, welcome. You may proceed.

STATEMENT OF RICHARD RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE

Mr. RAHN. Thank you. On behalf of our 200,000 members, I appreciate the opportunity to come before you today to talk about the impact of the tax changes made in 1981.

Now the proponents of the Roth-Kemp proposal argue that it would broaden the tax base by reducing the tax disincentives on work, saving, and investment, resulting in higher rates of economic growth and more employment and that the wealthy would pay a higher portion of the total tax burden.

Those detractors argue that tax cuts would be unfair to the poor. The CBO and others have used static analysis to build their arguments. They assume that there was an economic man out there who did not respond to changes in relative rewards of tradeoffs between work and leisure, between consumption and saving, between tax-sheltered and nonsheltered income. In other words, they ignored human behavior.

In fact, I found it rather inexcusable that the CBO in March 1984 came up with a projection claiming that the poor would pay an increased proportion of the total taxes and the wealthy less, when the actual data had been out 3 months previous for the year 1982 and at minimum I find that kind of analysis and projections dishonest.

But in essence, what has happened—and I fully concur with the two previous witnesses on their description of the effects of these tax changes—but what has been overlooked as a result of these changes is that now the United States has the fastest economic growth of any country in the world. Some of us can remember back to the mid-1970's and I think particularly of President Carter's malaise speech, where the argument was that we were a developed economy and hence we could not expect to grow much in the future, if at all, and inflation and high levels of unemployment would be with us forever.

But what has happened? The first quarter of this year we've grown at an 8.8-percent annualized rate. Over the last 12 months, we've grown at a 7.8-percent annualized rate, again, the highest growth rate of any country in the world. We have created 6.3 million new jobs in the last 18 months. We have created 890,000 new jobs in the month of May alone. That is more jobs than the European Common Market has created in the last 13 years. Yet they are complaining about us. There has been, I think, an undue focus on the Federal deficit, claiming that the tax cuts resulted in the high deficit.

We had a deficit problem that comes about primarily because of increased spending, but even so, the facts are that the deficit is coming down very rapidly.

Last year, the deficit was about $195 billion. This year, the Federal deficit is likely to come in between $160 and $168 billion and by the end of the year will probably be running at an annualized rate of about $130 billion.

At the same time, due to the economic recovery brought about by these tax changes, State and local governments are running a surplus in the $60 to $70 million range on an annualized basis.

The result of this is that our total governmental sector deficit now is about $100 billion, down substantially from last year. This comes out to be about 2.9 percent of our GNP, which is one of the lowest numbers of the major industrialized countries.

So when other countries of the world complain about our high deficits, I find they are being highly hypocritical. The Italians, for instance, are running a governmental sector deficit of 12.5 percent. So when you see countries around the world saying that our deficits bring on high interest rates, I look at this as nonsense.

Clearly, they have hurt their own economies by running both high deficits and high taxes, hence they have not created jobs in the way we have and they have not gotten out of the economic stagnation that has plagued so many countries during the 1970's.

My concern is that the forces who are trying to mislead the American people on this phony fairness issue are working to increase taxes and increased taxes would have a number of detrimental effects.

First of all, we have to realize that in this recovery we have had the most rapid rate of increased capital formation of any recovery since 1950. Plant and equipment spending has been up 16.5 percent during the last five quarters. The average of the postwar recoveries is only 8.4 percent.

The changes made in the capital cost recovery part of the Roth-Kemp tax bill have resulted in this rapid increase in investment spending and that has created jobs. There is nothing fairer than you can do for an unemployed person than to create a job for him.

If these things are changed, as has been proposed by some of the Members of Congress, and we go back to the old system, you can well expect that we will have reduced levels of capital formation, reduced levels of job creation, reduced economic growth, and a reduced increase in real per capita incomes for all our citizens.

We at the chamber are opposed to any tampering with the accelerated tax recovery program. We are opposed to the repeal of indexing. In fact, I find it a great irony that many of those politicians that want to repeal indexing claim they care about low income people. The repeal of indexing would not really benefit millionaires by more than an infinitesimal amount, but it would have enormous detrimental effects on low and middle income taxpayers. And I look at that as a great step backward.

Again, Mr. Chairman, I urge you and your colleagues to stick with the course that has brought this recovery about, that has caused the United States to have the highest rate of economic growth in the world, that has caused the United States to shift the tax burden from low income to higher income people, and has resulted in such a high rate of job formation.

Thank you very much.

[The prepared statement of Mr. Rahn follows:]

PREPARED STATEMENT OF RICHARD RAHN

I am Richard Rahn, Vice President and Chief Economist for the Chamber of Commerce of the United States. On behalf of our over 200,000 members, I would like to thank you for the opportunity for expressing our views on the fairness of the Economic Recovery Tax Act of 1981 (ERTA).

The Goal of ERTA

ERTA led to at least a 25 percent reduction of marginal tax rates for everyone and about a 7.5 percent reduction in the average person's tax liabilities. Single taxpayers making $41,500 or more and married taxpayers making more than $60,000, however, saw their rates reduced from 70 percent to 50 percent, or about 29%.

Proponents of the Reagan tax cuts urged that the tax cut would encourage more work, savings and investment and would lure the rich out of tax shelters and into taxable investments. This would increase the tax base and actually increase the share of taxes paid by the rich. Further, everyone would benefit from the economic growth sure to follow.

In effect, with the rate cut from 70 percent to 50 percent, the rich would both earn and "show" more income. In the long run, the tax cuts, by increasing the return to capital and labor could also lead to robust economic growth, an even greater expansion of the tax base and more economic benefits for everyone.

What ERTA's Detractors Said

Many doubted the efficacy of these "supply-side"incentive effects. They maintained that such a drastic cut of marginal rates would have no impact upon the tax base. As a consequence, less taxes would be collected from the rich and the poor would have to shoulder a larger percentage of the tax burden. Some have argued for three years that the tax cut favors the rich and have attempted to sell that notion.

This is a very sensitive issue and the resolution of the debate will influence the course of economic policy for decades to come. A recent volley in the continuing battle over the actual effects of the Reagan tax cuts was a Staff Analysis prepared by the Congressional Budget Office (CBO). The CBO study, entitled The Combined Effects of Federal Taxes and Spending Programs since 1981, was a static estimate of net tax reduction by income class and gave the distinct impression that the tax cuts would actually reduce the share of taxes paid by the rich and increase the poor's share. Some members of the press, ever eager to pounce on the "fairness issue", utilized the CBO study to attack Reaganomics. "Rich gain, the poor lose", read the headlines.

Reagan Tax Cuts Soak the Rich

The results for 1982 are now officially in. They show emphatically that incentives do matter. The percentage of taxes paid by the rich has increased while the percent paid by the poor has actually fallen.

The actual results for 1982 are shown in Table 1. They clearly document the powerful incentive effects triggered by the 1981 tax cut. The percentage of taxes paid by those in the income classes above $50,000 actually increased. Individuals making $1 million or more paid 42 percent more taxes in 1982, after the tax cut. As shown by table 1, a reduced share of taxes was paid by lower income groups.

The pattern is clear. If one wants to truly "soak the rich," the way to do it is to reduce high marginal tax rates. Some of the most able ministers of public finance, cognizant of the disincentive effects of taxation, have employed this tactic to boost both economic growth and tax revenues. In the nineteenth century, William Gladstone of England often employed the metaphor that imposing high taxes on the rich was like killing the goose that laid the golden egg. His tax cuts were an important ingredient in the booming economic growth of the British Empire during the middle and late nineteenth century. Andrew Mellon, Secretary of the U.S. Treasury during the 1920s, used the same policies to boost taxes paid by the rich. He argued, "Is it fair to tax the rich at a very high rate and collect a paltry amount or tax them at a lower rate but get more money?"

The Failure of Static Economics

Apparently, history seem easily neglected when it comes to examining the actual effects of the Reagan tax program. Although it was merely a static estimate, the CBO analysis, for example, was used as a basis for prediction, by others. The CBO simply "projected" tax shares by multiplying the previous tax base with a lower tax rate. This static arithmetic exercise would obviously lead to a smaller share paid by the upper income groups since the tax cuts were initially greater for this group. The CBO exercise was inexcusably misleading because they employed their static revenue estimates in a March, 1984 report even though actual results were available in January 1984.

Table 2 illustrates the large reduction in tax revenues found by CBO in its study. In 1982, for income categories above $40,000, CBO projected a $23 billion shortfall. The actual results show that tax revenues from this group actually rose by approximately $4.5 billion. This increase is all the more impressive since it occurred in during a deep recession. The marginal rate reduction caused higher income taxpayers to work more, invest more and to invest in higher risk-higher return assets; the lower rates also encouraged the rich to shelter less income, placing their resources instead in more productive areas. These effects were so powerful that they overshadowed the effects of the cyclical downturn.

Actual results for future years will almost certainly show greater taxes collected from higher income taxpayers, not less. Whereas many interpreted the CBO study to mean that the rich will be paying less in taxes in response to a cut in marginal tax rates, the available data indicates just the opposite. Apparently, when it comes to actual results, supply-side incentive economics is alive and well.

In the face of such overwhelming evidence, critics continue to quibble. John Berry of the Washington Post argues that the tax cuts have, nevertheless, been unfair since total income, in 1982, has fallen for income classes below $25,000. However, as the Wall Street Journal notes, this has little to do with fairness. The fact is that more lower bracket taxpayers simply moved up the income ladder. 20.6 million taxpayers claimed income between $25,000 and $50,000 in 1981, 22 million did so in 1982.

A legitimate concern is whether the wealthy paid increased taxes simply due to bracket creep. Are the rich simply paying more because this group is becoming larger through bracket creep?

Probably not. 1982 was a year of low inflation; the Consumer Price Index (CPI) increased by only 3.9 percent. Consequently, not much bracket creep occurred. Furthermore, the percentage of taxes paid by the rich has increased only in those years where they have received significant tax decreases. From 1973 to 1983, the most important bracket creep years, the sharpest rise in the percentage of taxes paid by the rich occurred only in those years which coincided with tax reduction. For example, the effective maximum rate on capital gains above $50,000 fell from 49 percent to 28 percent in 1978, then to 20 percent in 1981. It was over this same period that we experienced a significant increase in the percentage of taxes paid by the rich, the sole group for whom capital gains are an important source of income.

Why Most Economists' Forecasts Are Erroneous

Why is it that many, perhaps most, economists continue to believe that the path to higher tax revenues is to push tax rates even higher? The answer: because they fail to incorporate the incentive effects of taxation into their analyses. Within their macroeconomic models lurk a strange sort of "economic man," a person who does not respond to changes in the relative rewards or trade-offs between work and leisure, consumption and savings, tax-sheltered and nonsheltered investments. Human nature is blithely ignored.

The failure to consider the incentive effects of taxation is clearly stated, for example, in the statement of methodology in the CBO report. The report notes that their "estimates do not take account of an individual's behavior resulting from tax changes as they affect the household or the economy at large." In effect, this statement is equivalent to saying that "we are going to estimate the effects of Reaganomics by assuming that Reaganomics does not work." Recall, the point of Reaganomics was that the supply-side incentive effects of the 1981 tax cuts.

Indexing Must Be Retained

Beginning in 1985, the personal exemption and tax rate brackets will increase each year to compensate for increases in the cost of living as measured by the CPI. This provision is most important to lower and middle income taxpayers; wealthy taxpayers are already in the top bracket and therefore will remain subject to the same top marginal rate whether the tax code is indexed or not.

Tax indexing assures honesty and integrity in the tax policy process. It will prevent continued unlegislated increases in real individual tax liabilities that result entirely from the effects of inflation on the tax system. If tax indexing were repealed, individual and business taxpayers at the lower income levels would continue to be taxed at higher and higher rates. Furthermore, inflation would lessen the value of the personal exemption and zero bracket amount, which are relatively more important to lower income persons.

As noted above, the relative tax burden on the wealthy has increased over the past several years. This is because we have had de facto indexing. The 25 percent cut in marginal rates has benefitted lower income taxpayers disproportionately over the past several years; middle income taxpayers received a reduction in rates each year -- helping them to compensate for bracket creep -- while the highest income taxpayers remained subject to the highest marginal rates. The rate cuts helped lower income taxpayers avoid bracket creep, even though the code was not indexed. Inflation increased their nominal incomes, but not their real incomes, and would have forced them into ever higher tax brackets if the tax cuts were not taking effect at the same time.

The Congressional Research Service in its January, 1983 study noted that, because of narrower low income tax brackets and fixed personal exemptions, inflation disproportionately hurts lower and middle income taxpayers. It concluded that this continual increase in their tax burden will be stopped by indexing. Instead of increasing the burden on the middle income taxpayers, it concludes that "once indexation begins this new distribution will, for all practical purposes, be 'locked in'". That is certainly preferable to increasing the burden on middle income taxpayers by continued and unlegislated bracket creep.

Record Capital Formation

The Accelerated Cost Recovery System (ACRS) was a cornerstone of ERTA and it is working. Replacement of the inadequate Asset Depreciation Range (ADR) system with ACRS cut the cost of capital and allowed businesses to make the investment in plant and equipment needed to drive the recovery. Nonresidential fixed investment (equipment and machinery) has increased by 16.5 percent in the five quarters since the recovery began in the fourth quarter of 1982. This is the highest rate of capital formation in any recovery since 1949 (when it grew at 22.5 percent). The average increase during post-1950 recoveries is 8.4 percent, half of the present rate.

CAPITAL FORMATION DURING THE RECOVERY

Recovery Began	Five Quarter Percentage Increase in Fixed Nonresidential Investment
1949	19.1
1954	15.3
1958	10.5
1961	10.7
1970	6.3
1975	8.8
1980	7.8
Average of all 7	12.1
Average last 4	8.4
1982 most recent	16.5

CAPITAL RECOVERY DURING THE RECESSION

Quarters After Peak	Average of Seven Postwar Recessions	Last Recession
1	-2.0%	+0.2%
3	-6.4%	-4.1%
5	-14.2%	-7.5%

Capital formation did not fall nearly as much during the last recession because of ACRS.

Increased capital formation increases productivity, employment and competitiveness. Because pre-ERTA allowances were insufficient, the U.S. economy has fallen behind, stagnated and become uncompetitive. Our capital stock is much older than our trading partners because our allowances have been insufficient for decades. Any further cutbacks in ACRS will sabotage the progress made to date.

The tax law has undergone many changes over the last seven years -- often several major changes in one year. Businesses have watched tax cuts be enacted only to be undone within the year. This sort of activity makes it difficult to plan. Moreover, it makes every tax reduction suspect and therefore reduces the efficacy of its incentive effects.

Many businesses choose not to take "advantage" of new tax incentives because they expect the new advantages to disappear. They will not make marginal investments on the basis of tax provisions if they expect them to disappear, thus rendering their investments unprofitable.

ACRS under ERTA was simple. The Tax Equity And Fiscal Responsibility Act of 1982 (TEFRA) introduced new complexities. Any additional attempts to decrease depreciation allowances will just add complexity. This ever increasing complexity is rapidly undoing the progress made in 1981.

One of the most important incentive effects of lower taxation is the increased reward to both savings and investment. Lower marginal tax rates reduce the tax wedge that exists between savings and investment. It simultaneously increases the after tax reward to savings and the after tax return on capital investment. As Dr. Norman Ture, former under secretary of Treasury for tax and economic affairs, notes, this has been an important characteristic of the current expansion. The recovery has been literally driven by gross private investment.

Dr. Ture states that real gross private domestic investment surged ahead by 37.4 percent from the fourth quarter of 1982 through the fourth quarter of 1983, a growth rate almost seven times that of consumption, and substantially faster than the 26.4 percent average of the first-year growth rates of investment spending for prior postwar recoveries. Producers' durable equipment outlays were up a remarkable 20.3 percent, almost double the average first-year postwar recovery rate. Residential investment, presumably a casualty of "gigantic federal budget deficits", increased during the first year of the current recovery by 37.4 percent, more than twice the postwar average first-recovery-year rate. Consumption certainly has not been the prime mover of this recovery to date. Capital formation has provided most of the momentum.

The Future Course of Fiscal Policy

As we look beyond the impact of the 1981 tax cut on 1982 tax revenues, the positive incentive effects of the tax cuts continue to unfold. The robust expansion presently underway has developed unexpected speed and power. The incentive effects of taxation have played an important role, particularly in business fixed investment. The effects of lower taxation not only contributed to the rising tax share paid by the rich, but also to the strength of the present economic recovery.

What this adds up to is a surprisingly large increase in the tax base. The incentive based tax cuts have been responsible for a 12.5 percent increase of taxes collected in the first seven months of 1984 compared to 1983. In effect, economic growth is increasing federal revenues at the same time it is cutting federal spending. Better business conditions have resulted in higher tax revenues and reduced unemployment benefits. If this trend continues, the FY'84 deficit would be $37 billion less than the $195 billion FY'83 deficit.

Having failed to make much of a dent in the federal budget, some now cast their eyes upon so-called tax "reforms" to close the deficit. For the most part, this translates into a euphemism for major tax increases. But where are the tax revenues to come from?

Evidence provided by the Internal Revenue Service (IRS) indicates it will not come from the rich. Increasing tax rates which the rich will simply drive them into tax shelters and reduce federal revenues. The Grace Commission has calculated that even if the IRS confiscated one hundred percent of all remaining taxable income above $75,000, it would run the government for no more than ten days.

This means that any tax increase will come out of the paychecks of lower and middle income class taxpayers. This group accounts for ninety percent of all personal income tax payments. Their 1981 tax cuts have already been whittled away by bracket creep, Social Security tax increases, and higher excise taxes. How much further can we dip into their pocketbooks?

The message should be clear by now. Any major assault on the federal deficit must be based on cuts in the growth of federal expenditures. An increase in tax rates would create strong disincentive effects that would eradicate any gains made by reducing the demand for credit by the federal government. Furthermore, it would not lead to anything like the increased tax revenues that proponents of tax increases claim. We must face up to the problem that the federal government is an extravagant spender, and that one does not cure the habits of an extravagant spender by providing him with more funds.

Conclusion

The results of the 1981 tax cut are filtering in. They show that these tax cuts have had strong incentive effects. They have increased the share of taxes paid by the rich by causing them to produce more and to shelter less income. They have been a prime ingredient in the current economic expansion. ACRS has caused a dramatic increase in capital formation which is vital for continued economic growth. This proven success should place the focus of deficit reduction on the expenditure side of the ledger. Major tax increases threaten to reverse all the gains that have been made so far.

TABLE I

TAX SHARE UNDER ERTA 1981-1982 CUT
(Millions of $)

Net Income Group	Tax Revenues Collected ($)		Change (%)	Share of Taxes Paid	
	1981	1982		1981	1982
$0-10,000	8,634	7,627	-12%	3.0%	2.7%
$10-15,000	17,680	15,873	-10%	6.1%	5.6%
$15-20,000	23,385	20,425	-13%	8.0%	7.2%
$20-50,000	145,412	140,135	-4%	50.0%	49.1%
$50-100,000	52,156	51,732	-1%	17.9%	18.1%
$100-500,000	34,613	36,723	+6%	11.9%	12.9%
$500,000-1,000,000	4,118	5,719	+39%	1.4%	2.0%
$1,000,000 and up	4,901	6,945	+42%	1.7%	2.4%
TOTAL	290,900	285,179	-2%	100.0%	100.0%
Summary					
Under $20,000	49,699	43,925	-12%	17.1%	15.5%
$20-50,000	145,412	140,135	-4%	50.0%	49.1%
Over $50,000	95,788	101,119	+6%	32.9%	35.4%

Source: U.S. Treasury, Office of Tax Analysis.

TABLE II

CONGRESSIONAL BUDGET OFFICE ESTIMATES OF TAX CHANGES RESULTING FROM ERTA AND TEFRA BY INCOME CATEGORY CALENDAR YEARS 1983-1985

($ billions)

		Household Income				
Calendar Year	All Households	Less Than $10,000	$10,000 20,000	$20,000-40,000	$40,000-80,000	$80,000 and over
1982	-37.8	-.1	-1.0	-13.6	-16.0	-7.1
1983	-68.0	-0.1	-4.9	-25.1	-27.8	-10.0
1984	-93.6	-0.4	-7.3	-35.0	-38.8	-12.1
1985	-115.9	-0.9	-9.8	-44.1	-47.9	-13.3

Source: Congressional Budget Office. Based on CBO economic projections of February 1983.

Senator JEPSEN. I thank you.

Mr. Lawrence Pratt of the American Institute for Economic Research. Again, your prepared statement will be entered in the record. You may proceed.

STATEMENT OF LAWRENCE PRATT, ECONOMIC JOURNALIST, AMERICAN INSTITUTE FOR ECONOMIC RESEARCH

Mr. PRATT. Thank you, Senator Jepsen and Senator Roth, for including me in this hearing.

I'm a simple economic journalist from Great Barrington, MA. We get a certain sense of detachment up there.

ERTA, the Economic Recovery Tax Act of 1981, was a very unusual event in economics. It was a sudden change in rules, incentives, and rewards that were available to a very small group, those with high property incomes. The top rate went from 70 percent to 50 percent.

Economists, as behavioral scientists, don't get an opportunity like this very often, and one of the things that has astonished us is how little attention was devoted to this. The advocates of the bill, as the preceding witnesses have said and as subsequent evidence seems to show, said that this would actually increase the returns from this group. I tried very early to get some evidence of this which I found by looking at the other component of income tax receipts which is reported monthly by the Treasury. This is obviously only an indication, but it is where people pay taxes on high property income.

You recall that the rate on so-called earned income stayed at 50 percent. It was 50 percent in 1981 and 1982, although with the complexity of the law, someone might have actually wound up paying a little bit more than 50 percent on earned income if he also had property income.

But in any event, this series—the other component of income tax receipts—rose sharply during 1982 in the teeth of a severe recession and, in fact, it came in something like $9 billion over the Treasury Department's estimates for fiscal 1982 made in January of that year.

To me, this indicated that there was some sort of supply-side response, but we had to wait until we had data on the actual returns. We got the data for 1982, thanks to the Government Printing Office and the U.S. Postal Service, in mid-March, although they were dated January 31. Nonetheless, out came the CBO report with the numbers on the board there, which were made on static assumptions, assumptions that, in fact, could have been made at the time the law was written, maybe with a little adjustment for what actual inflation turns out to be during those years. As Mr. Rahn said, I think this was dishonest, even though this analysis and related analyses have received enormous play in the press and in the editorial pages, especially.

The fact is that the 1982 data indicate that the top group received more taxable income, earned more taxable income, or elected to report more taxable income. It makes little difference. They paid more taxes because their taxable income went up.

I'd like to make a point about this whole issue of taxing the rich or of not taxing the rich. It is something of a sideshow as far as economics goes. We are talking about a very small group. It seems to be more symbolic than anything else.

If you want to close the deficit by raising more revenue, you are not going to get it out of that group. There simply isn't enough income in the aggregate. The bulk of taxes are paid in the middle. The poor don't have enough income, and the rich as a group don't have enough income. So if you're talking about fiscal policy and tax changes, the major burden, or the major gains are going to be received in the middle in terms of large dollars.

But back to this small group, it is true that they received more taxable income and they probably paid more taxes. This seems to annoy people, that the rich seem to have gotten richer. This is pure envy, in my view. But it illustrates an important point I'd like to mention and touch on, something Senator Roth said about savings. I would agree that savings are important. It's more important to refrain from discouraging savings than encouraging savings. Savings in and of themselves aren't necessarily a good thing. Centrally planned economies, Eastern Europe, Communist China, have had extraordinary high rates of capital formation and it hasn't done them any good because they don't know what to do with it. They don't have the mechanisms to properly invest what they save at a decent rate of return.

The rate of return is equally important. So the real issue here on taxing the rich, or taxing anybody else, is how much are you going to let a producer keep? If people choose lightly taxed but inefficient uses of resources because they are better off after that, rather than going for efficient but highly taxed uses, then the economy suffers as a whole. And the reverse is true. I think that's something of what we're seeing now in this recovery. We are seeing people able to use their resources to reward themselves and in the process, everybody else benefits too.

The increased taxable incomes of the rich, which is what the data we're discussing indicate, also mean more incomes throughout the economy—economic growth, in other words.

The important thing is reducing the rates at the margin. There have been tax cut bills any number of years since the last major rate cut in the Kennedy round, but the cuts have been targeted. There have been a little more exemptions here enlarging this deduction there, and so forth. That has quite a fiscal impact, but I don't think it does much for economic growth. The important thing to keep in mind is to keep the rates down at the margin as low as possible.

I would say that to really get somewhere, you have to attack the constraints on the people in the middle regarding what their incentives and rewards are. Below, say—I don't know—it depends on whether you're married or not, but below $50,000 or $100,000. The marginal rates haven't changed that much since ERTA because you have had 20-percent inflation since it was enacted, and that's almost equal to the 23-percent cut.

I think it has been helpful and it is a move in the right direction, but I think the Nation needs a lot more.

Thank you very much.

[The prepared statement of Mr. Pratt, together with attachments, follows:]

Prepared Statement of Lawrence Pratt

Since the modern income tax was first levied in 1913, the Economic Recovery Tax Act of 1981 (ERTA) was only the third instance in which the basic rate schedules were substantially reduced. (The other two were the so-called "Kennedy" tax cuts of 1964 and the "Mellon" cuts 40 years before that.) Over the years, there have been numerous other tax cuts, but they usually involved enlargement of exceptions to the basic rates. One observer (Michael K. Evans) has estimated that the percentage of any increase in personal income that was paid in taxes (including state, local and Federal income taxes and Social Security taxes) was about 10 percentage points higher in the late 1970's than it was in 1965 after the Kennedy tax cut. This increase in the *marginal* tax rate was accompanied by an increase of only 4 percentage points in the *average* tax rate, or total personal taxes as a proportion of total income. This divergence between the changes in the average rate and the marginal rate reflected "bracket creep," caused by the interaction of inflated incomes and progressive rate schedules, and the use of "targeted tax cuts" during the years 1965-1980. In 1980, the Consumer Price Index (CPI) increased 13.5 percent. Those whose incomes kept up but who had no real gain in pre-tax income paid higher real taxes. The extent of this unlegislated tax increase for a family of four at various income levels is shown in Table 1.

The 13.5 percent increase in the CPI for 1980 followed increases of 11.3 percent in 1979, 7.7 percent percent in 1978 and 6.5 percent in 1977. Individual income taxes (national income accounts basis) increased from 10.5 percent of each (non-imputed) personal income in 1976 to 11.9 percent in 1980 despite some tax reductions, including a drop in capital gains tax rates, during those years. By 1980 the time was ripe for a major tax reduction as the effects of bracket creep were becoming too pronounced to be ignored by the administration or Congress, no matter who was in office.

Table 1

"Bracket Creep" in 1980 for a family of four

1980 Income	Inflation-induced tax increase*
$10,000	$ 297
20,000	252
30,000	521
50,000	1,179
100,000	2,524
200,000	4,271
500,000	4,863

*Excess of 1980 Federal income taxes over 1979 taxes, expressed in 1980 dollars for a married couple with two dependents and no deductions, tax credits (except the earned income credit), or adjustments to gross income and whose income increased as much as the CPI between 1979 and 1980.

Before considering the changes that were actually enacted in ERTA, it is worth examining bracket creep further. As Table 1 suggests, the effects of bracket creep fall proportionally more on those with lower incomes. (The $10,000 family was subject to a double whammy in 1980, not only because more of their income was taxed at a higher rate, but also because the workings of the earned income credit added 12.5 percentage points to their marginal tax rate.) Inflation-induced income gains have a proportionally larger impact on taxes in the lower income ranges, because the brackets are narrower at the bottom. At the top, taxpayers are less affected by bracket creep. The marginal tax rate can creep no higher than the top. The tax liabilities of those in the top bracket are only inflated to the extent that income taxed in the top bracket becomes a larger proportion of total inflated income.

One of ERTA's key provisions was to "index" taxes starting next year (1985),so that any gains in nominal income which simply reflect a loss of purchasing power of the dollar will not lead to lower real after-tax incomes and purchasing power. If the indexization of tax brackets and other provisions fixed in dollars is postponed or repealed, the impact will be proportionally largest on taxpayers with the smallest incomes. Any resultant increase in tax receipts will mainly be paid by taxpayers in the middle (say, $20,000 to $75,000) because such taxpayers receive most U.S. income and pay the bulk of income taxes. Of course this latter aspect is inescapable: any prospective increase in taxes designed to increase Federal revenues will mainly affect those in the middle: neither the "poor" nor the "rich" have sufficient aggregate resources for tax changes to make a substantial impact on tax receipts from those groups.

The major provision of ERTA was a phased-in reduction of tax rates "across the board." Starting with a 1¼ percent tax credit against 1981 tax liabilities, rates were reduced in all brackets during 1982, 1983 and 1984. The overall reductions totaled about 23 percent (with some variation due to rounding tax rates to whole numbers). In addition the top marginal rate was reduced in the first year (1982) from 70 to 50 percent, a 28.6 percent reduction.

At the time of enactment, official projections were for a 25 percent decrease in the purchasing power of the dollar over the four-year span that tax rates were to be reduced. Thus, it was expected that the ERTA rax rate cuts would be slightly less than the effects of bracket creep for most taxpayers whose incomes kept up with the cost of living between 1980 and 1984.

As it turned out, prices increased less than was expected: the purchasing power of the dollar is now "only" about 20 percent less than four years ago, which means that most taxpayers received small real income tax cuts instead of slight real increases between 1980 and 1984. (For wage and salary earners this was offset by increased Social Security taxes.) It was this underestimate of price inflation combined with the effects of the 1981-82 recession (also unanticipated at the time ERTA was passed), that produced the large shortfall of Federal income tax receipts from earlier projections.

But ERTA was designed not so much to reduce tax payments in real terms (except in relation to what they might have been if bracket creep had continued unchecked) as to reduce marginal tax rates. In Table 2, I have shown the average and marginal Federal tax rates (including both income and Social Security taxes) for 1980 and 1984 and the percentage point change between those years. I have also shown the total taxes due and the 1980 to 1984 change, expressed in 1980 dollars. As in Table 1, these were computed for families of four with uncomplicated tax returns.

It should be stressed that the data in Tables 1 and 2 are artificial. Few taxpayers today have uncomplicated returns. Above relatively modest income levels, virtually none do. At a minimum, this means that anyone who is paying the 1984 taxes on the income levels shown in Table 2 is likely to have a higher income in any generally understood sense. Nevertheless some general observations seem warranted.

First, ERTA did not actually produce significantly reduced Federal taxes in real terms for most taxpayers. In fact, real tax liabilities (including Social Seuurity taxes) increased slightly for real incomes in the range in which the vast majority of taxpayers are found.

Table 2
Change in Combined Federal Income and Social Security Taxes
Married Worker with 2 dependents
1980 to 1984* (dollar amounts in 1980 dollars)

Income	1984 Taxes	Change from 1980	Average Tax Rate (%)			Marginal Tax Rate (%)		
			1980	1984	Change	1980	1984	Change
$10,000	$ 1,140	$+153	9.9	11.4	+1.5	22.1	20.7	-1.4
20,000	3,562	+71	17.5	17.8	+0.3	30.1	28.7	-1.4
30,000	6,870	+332	21.8	22.9	+1.1	32.0	34.2	+2.7
50.000	13,900	-505	28.8	27.8	-1.0	49.0	42.0	-7.0
100,000	35,927	-5,299	41.2	35.6	-5.6	59.0	49.0	-10.0
200,000	85,571	-20,328	53.0	42.8	-10.2	68.0	50.0	-18.0
500,000	235,571	-79,940	63.1	47.1	-16.0	70.0	50.0	-20.0

*Calculations assume no deductions or tax credits and no exclusion for dividend income, alimony paid, contributions to a retirement plan or other adjustments to gross income (nor do they reflect the maximum tax on earned income for 1980). Income up to the maximum subject to Social Security taxes ($25,900 in 1980 and $37,800 in 1984) is presumed to be earned by one source only.

Second, marginal tax rates did decrease "across the board" between 1980 and 1984. The ERTA decreases were offset by the increased Social Security taxes of 0.6 percentage point where applicable and, because the Social Security tax base rose faster than the CPI, the marginal rate on wage and salary income may have actually increased for a few souls who had managed to receive a small portion of their pay free of this tax in 1980 but not in 1984. (This is the cause of the 2.7 percentage point increase in the marginal rate of the $30,000 family shown in Table 2.)

Finally, it is clear that ERTA significantly reduced the marginal tax rate on those with higher incomes. However, the individual income tax schedules remain sharply progressive. The 1984 rate schedules call for a family of four with 10 times the income of a $10,000 family to pay 30 times as much tax and for a family with 50 times $10,000 of income to pay 200 times as much.

Since the time it was first proposed, critics and opponents of ERTA have focused on the extent of the tax reduction for upper-income taxpayers that the new rate schedules called for. This lies at the heart of the so-called fairness issue with respect to ERTA. But as anyone who has even looked at a form 1040 recognizes, there can be vast differences between "income" in a generalized sense of the word and what appears on the line labeled "taxable income."* At some level of marginal taxation, an individual will begin to consider the tax consequences of decisions to work, save or invest. This level cannot be determined precisely (and it probably varies among individuals), but there can be little doubt that anyone who was subject to the top 70 percent marginal rate in 1980, made few, if any, financial decisions in which the tax implications were not considered.

---

*In strict economic terms, an individual's income in a given period can only be defined as total consumption plus change in net worth adjusted for price level changes. What is taxed on form 1040s is only vaguely related to this, especially if the taxpayer holds assets or is a net debtor or creditor.

Even people facing much lower marginal rates probably make tax-influenced choices concerning work vs. leisure, taxable vs. non-taxable investments, do-it-yourself vs. paying for services, "on-the-books" vs. "off-the-books," and so forth. Choices that taxpayers make to avoid or evade taxes not only serve to shrink the tax base but also retard economic growth. The economy as a whole reflects countless individual choices and if the tax laws drive people toward inefficient but lightly-taxed uses of resources and away from more efficient fully-taxed uses, then the economy as a whole suffers.

Serious analysts have recognized that the "fairness" issue cannot be assessed simply from the relationship between the old and new rate schedules without reference to any changes in actual taxpayer behavior. Unfortunately, measuring the effects of ERTA on the tax base and on resource allocation are incomparably more difficult to measure than is analysis of the effectsof the new tax schedules on hypothetical taxpayers (as I have done in Tables 1 and 2). The latter type of analysis has dominated discussions of the effects of ERTA since it was first proposed.

The latest and most exhaustive attempt was a March 1984 staff memorandum of the Congressional Budget Office (CBO), "The Combined Effects of Major Changes in Individual Income and Excise Taxes Enacted in 1981 and 1982 for Households in Different Income Categories." Astoundingly this study relied on "static estimates ...based on the somewhat [!] arbitrary assumption that ... changes in the tax code do not have significant effects on general taxpayer behavior or otherwise on the economy at large." This methodology effectively precluded any findings that ERTA had worked in ways that its advocates had expected.

With this methodology, it should have been no surprise that the CBO found that the "rich" benefited far more from ERTA than the "poor." ERTA's opponents reacted to their findings like felines to catnip. The New York Times editors proclaimed that the CBO was "a professional, not a partisan, organization." And they asserted that "it seems clear that the rich have gotten richer and the poor poorer."

However, as behavioral scientists, professional economists must look when possible to actual evidence of human behavior. Such evidence, IRS and Treasury reports of changes in actual tax payments, was available to the CBO well before their study was published. In terms of the ethics of the economics profession, I can only call the CBO's methodology scandalous. If anything the actual data on tax collections have indicated that high income taxpayers have paid a larger proportion of the Treauury's total income taxes since ERTA even though ERTA gave them the largest reduction in tax rates. I have appended an article on this subject, portions of which appeared in The Wall Street Journal for May 1, 1984. (I have also appended a letter from Mr. Rudolph Penner and an editorial from the Journal, that relate to this article.)

ERTA presented a rare opportunity for economists: a significant sudden change in the rewards and penalties applicable to a relatively small but heterogeneous group: those who have high property incomes. One might have expected that a major effort would have been made to ascertain what these changes have been especially on the part of those who have a major interest in the subject and who have the quickest access to the available data: the Treasury and the CBO for example.

I hope these hearings will prompt those with the best abilities and resources to determine what actually happened. I believe that actual tax liabilities this year may well be more "progressively" distributed in 1984 than in 1980, i.e., that as a result of ERTA, upper-income taxpayers now account for a larger proportion of all personal income taxes due. If this proves to be the case, attacks on ERTA as "unfair" can be based on envy alone.

Lawrence S. Pratt
American Institute for Economic Research
Great Barrington, Mass. 01230

Published by
AMERICAN INSTITUTE
for ECONOMIC RESEARCH
Great Barrington, Massachusetts 01230

RESEARCH
REPORTS

Vol. LI No. 9 May 7, 1984

The CBO Report: "Facts" for the Occasion*

A key idea of supply-side economics is that lower tax rates encourage more productive effort and incomes. The 1931 tax bill provided "across the board" income tax rate cuts. But for most taxpayers there has been little actual tax relief, because rate cuts have been offset by "bracket creep" due to inflated incomes. The major exceptions were the high-income taxpayers, for whom the top rate dropped from 70 percent in 1981 to 50 percent in 1982. The share of income taxes paid by the top group increased in 1982, and their actual taxes paid decreased much less than the rate cuts implied. This was a classic supply-side response. The Congressional Budget Office, which purportedly provides Congress with accurate and nonpartisan information, recently produced a widely reported analysis of the effects of changes in Federal taxes and spending on various income groups. In suggesting ERTA was more advantageous to the "rich" than the "poor," this report completely disregarded actual tax changes, relying on estimates based on the assumption that taxpayers' behavior is unaffected by tax rate changes. The politicians seem to prefer the belief that citizens do not act on their own initiative and can benefit only from politically targeted tax and spending programs.

Since the Economic Recovery Tax Act of 1981 (ERTA) was first proposed, critics have decried the dollar magnitude of the prospective tax savings of the "rich" (large) and of the "poor" (small). These dollar magnitudes are calculated by applying the lower tax rate to an estimated amount of taxable income which amount is assumed to be the same under the high-rate tax structure as under the low-rate structure. This is called a static analysis of tax revenues. The supply-side rationale for the cuts, that lower rates would foster higher taxable income, was dismissed as a sort of eccentric nuttiness, at worst, or something that cannot be tested, at best.

Not the least reason for this has been the Administration's failure to enunciate and repeat at every opportunity the original supply-side rationale. Instead, the Administration's tendency has been to respond to the critics with some variation on the theme: "Golly, we treated everyone the same." As recently as at his April 4 news conference, the President answered a hostile question on this subject with, ". . . there is no way that the tax program could have benefitted someone at one end of the scale and not the other. It's based on proportions." By now, however, it should not be necessary to guess about the response of taxpayers to the Reagan tax cuts. The initial evidence is in, and it is consistent with the supply-side rationale.

In 1982, the first full year after ERTA, most Americans received little or no real income tax relief. Personal income tax rates were indeed 10 percent lower "across the board" than in 1981, but nominal incomes were driven up by inflation (6.0 percent as measured by the GNP deflator). Therefore, the 1982 reductions mainly offset "bracket creep," and for most groups marginal income tax rates changed little.† Persons with high property incomes were a major exception – the top rate on such income dropped from 70 percent in 1981 to 50 percent in 1982.

Here at the American Institute we looked to the nonwithheld ("other") component of Federal individual income tax receipts for an early sign of a supply-side response to ERTA. In the summer of 1982 we noted that the 12-month total of this "other" component, which is where quarterly estimated tax payments on property incomes are reported, had increased to a 9-year high as a proportion of individual income tax receipts. (It has since remained higher than at any time during the years 1973-81. See Chart 1.) We subsequently reported that for fiscal 1982 the "other" component was $7.9 billion higher than in fiscal 1981 and $9.7 billion more than had been forecast by the Office of Management and Budget in February of that year. The amount had increased, when the static analysis of the budgeteers had foretold a decrease.

In fiscal 1983 the "other" category was the only major category of Federal receipts to exceed the early-1982 budget projection. This was all the more remarkable because the economic assumptions used in that budget projection were grossly optimistic, and thus one would have expected taxable incomes, and thus tax revenues, to be much lower than projected.

The trend of non withheld, or other, individual income tax receipts is influenced by many factors. Collection procedures and the timing of payments are two. Therefore, the early data were never more than an indication that the rich were paying a larger share of ta[illegible]. Confirmation had to await publication of detailed data from the 1982 tax returns. These recently became available. (The date over the signature of the Commissioner of Internal Revenue is January 31.) One of the first reports of these data was in a *Wall Street Journal* editorial of April 11. There the editors used the data, as presented in Table 1, to show that for groups with incomes of less than $50,000, the *share* of taxes paid in 1982 was lower than it was in 1981 and that for groups above $50,000 the share was 2.5 percentage points higher. The Reagan "tax cuts for the rich" had, if anything, shifted some of the income tax burden away from the poor.

Table 1
TAX SHARE UNDER REAGAN 1981-82 CUT*

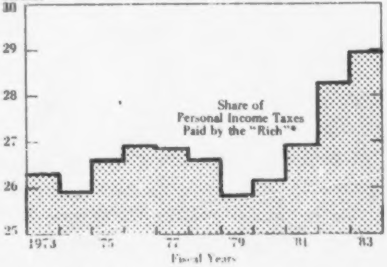
Actual data for tax liabilities confirm that higher income taxpayers paid a larger share of individual income taxes in 1981 than in 1982.

	Percent Share of Taxes Paid	
Net Income Group	*1981*	*1982*
$0 – 10,000	3.0	2.7
$10 15,000	6.1	5.6
$15 – 20,000	8.0	7.2
$20 50,000	50.0	49.1
$50 – 100,000	17.9	18.1
$100 500,000	11.9	12.9
$500 – 1,000,000	17.9	18.1
$1,000,000 & up	1.7	2.4

* From *The Wall Street Journal*, April 11, 1984.
Source: U.S. Treasury.

Chart 1

In 1982 and 1983, after the top individual tax rate was cut to 50 percent from 70 percent, "voluntary" income tax payments increased in relation to withholding receipts.



* Taxes paid by the "rich" are taken to be all income taxes paid by individuals other than those withheld on wages and salaries. The most recent level of this series was 28.5 percent for the 12 months ended January 1984.

---

* A briefer version of this report was published on the editorial page of *The Wall Street Journal*, May 1, 1984.

† The marginal tax rate is the rate on the highest dollar of taxable income.

Washington Can't Be Bothered with the Facts

The most widely quoted attempt to assess the effects of "Reaganomics" has been a March 1984 staff report of the Congressional Budget Office (CBO) called "The Combined Effects of Major Changes in Federal Taxes and Spending Programs Since 1981." Its findings usually have been distilled to an estimate that between 1981 and 1984, households with less than $10,000 income "lost" $820, while households with over $80,000 income "gained" $8,270 as a result of the "Reagan revolution." A subsidiary report indicates that the $8,270 figure was more than accounted for by average estimated ERTA tax savings of $8,750 by top-income households this year (1984). For this group ERTA was estimated to have "saved" $7,510 in 1983 and $5,100 in 1982.

In Table 2 we have shown (1) the *average tax per return* for the various income groups used in the CBO study and (2) the change from 1981, in percent and in dollars. As one should expect in the light of the top group's large tax liabilities, the dollar decrease in the top group (over $75,000 adjusted gross income) was the largest. But the 2.7 percent per return decrease in the top group was proportionally by far and away the smallest.* By static analysis it should have been the largest, because 1982 was a year of recession (property income is more cyclical than wages, contrary to popular myth) and because of the large drop in the brackets that were over 50 percent in 1981. In short, the data strongly suggest that there was a supply-side response to the Reagan cuts.

Although the CBO estimates for the 1982 tax savings of the lower income groups (shown in the last column of the table) are reasonably close to the actual dollar changes on tax returns from 1981 to 1982, the $5,100 figure for its top group is *overstated by a factor of more than four.* (Simple arithmetic reveals that the 1982 average tax liability on returns with over $75,000 adjusted gross income was about $1,210 less than in 1981.) This error cannot be explained by definitional differences, such as "households" vs. "returns" or over $80,000 vs. over $75,000 grouping. The CBO acknowledged that its figures are "... static estimates based on the somewhat arbitrary assumption that ... changes in the tax code do not have significant effects on general taxpayer behavior." This makes about as much sense as saying that motorists are unaffected by road signs and police cars.

We shall have to wait for the 1983 and 1984 tax return data to learn more of what actually happened. No massive cuts for the rich were made in these years. The CBO's estimated $3,650 additional ERTA tax savings for its top group (from $5,100 in 1982 to $8,750 in 1984) apparently reflects 1983 and 1984 cuts in the brackets under 50 percent (high-income taxpayers pay tax in all brackets). However, given (1) the small actual 1982 change in relation to the average total paid, (2) the cyclical rebound of property income, and (3) the additional time in which to re-deploy assets, the possibility cannot be ruled out that the top group will pay more taxes on average in 1984 than they did in 1981.

On the other hand, it is possible that high-bracket taxpayers took steps to delay receipt of 1981 income in order to be taxed at the lower 1982 rates (thereby distorting the 1982 data) or that post-1982 "revenue enhancement" measures will discourage the rich from generating taxable income. Only time will tell.

We are not in a position to dissect the CBO's estimate of the $820 average "loss" of under-$10,000-income households between 1981 and 1984. Apparently it involves some estimate of what various income-transfer outlays would now be under 1981 law and apportioning the difference from current 1984 estimates among income groups. The questionable accuracy of a figure derived from the difference between two guesses divided by a third guess is one reason to doubt the usefulness of the CBO's approach. But even more condemning is that it totally ignores the possibility that low-income groups benefited from the 4 million increase in employment since 1981, at least some of which may have been due to a supply-side boost to output.

Behind Closed Minds

It is probably too much to ask that the media headline the CBO report with "Congressional Aids Publish Fake Data" instead of "Rich Gain, Poor Lose," even though it is scandalous that the CBO could have continued to employ static estimates of tax changes after actual results were available. But it is, alas, all too understandable that the CBO report came out the way it did, given the question the staff was asked to answer: How has government policy affected the distribution of income? Economic changes that reflect the spontaneous decisions of producers and consumers are suspect or ignored in Washington. "Inside the beltway" it seems that only Government policy matters.

Economic change fostered by market forces has long been fought by the politicians. For example, Government grants extraordinary assistance to areas of high unemployment and thereby discourages out-migration of persons to places where opportunities are greater. Government thus prolongs the agony of the "rustbelt." The same attitude finds more to celebrate in the Chrysler bailout (which "saved" the jobs of a relative handful of workers whose wage rates are higher than most of the taxpayers who paid for the bailout) than in the over 5 million net gain in employment since December 1982. The latter jobs presumably are more closely matched to providing consumers with what they want at a price they can afford than were the 1 million jobs that were eliminated (net) during the years 1980-82.

That the average income tax payment of the rich decreased only about $1,200 while the CBO's static analysis estimated a decrease of about $5,000, of course does not indicate that the rich failed to benefit as much as those with lower incomes. It simply indicates that the *taxable* incomes of the rich increased substantially more than those in other groups. Although the ability of individuals to spend and invest their own money with less regard to artificial "tax consequences" benefits the economy as a whole, its impact on the economy would have been small in 1982. Only about 1 percent of all taxpayers were involved. Not until 1983, when the "across the board cuts" exceeded the effect of "inflation," was there much supply-side incentive for the vast majority of taxpayers to respond to. The unexpected vigor of the current expansion and perceived improved attractiveness of the United States as a world investment haven may be a result.

That governments cannot make someone better off without robbing someone else is well understood. The fairness issue can never be resolved to universal satisfaction because what one group perceives as fair another group will not. Economic analysis cannot provide warranted assertions about what is or is not fair. However, the study of economics can be used to determine whether government policies and actions foster or retard human progress.

As for fiscal policy (Government spending, taxation, borrowing and lending), the issue is how much of the Nation's resources are taken or directed by Government not only in total but also *at the margin* of decisions to work, spend, and save. Some taxes, such as those on site-values or even head taxes in underdeveloped countries, can actually promote economic activity. Others can stifle it or force activities underground.

Supply-siders deserve much credit for drawing attention to the latter issue. But their achievements to date have been quite limited, for all the rhetoric. Marginal tax rates remain high, while the total taxes collected are inadequate to pay for the spending voted by the politicians. The reason, of course, is that the politicians love to take credit for the special provision of the tax laws that provide "relief" to specific groups just as they love to spend for the benefit of favored special groups. That the economy as a whole suffers as a result seems to be beyond their comprehension or concern.

Table 2
INDIVIDUAL INCOME TAXES AFTER THE 1981 TAX CUT

The average 1982 tax savings of the top income group were only about one-fourth as large as estimated by the CBO and in relation to taxes paid were much smaller than for the other income groups.

Adjusted Gross Income (Dollars)	Actual 1982 Tax Payments			
		Change from 1981		
	Average Tax per Return	Percent	Dollars	CBO Estimate*
Less than 10,000	$ 210	6.1	$ 14	$ 10
10,000 to 20,000	1,410	-10.3	-162	-130
20,000 to 40,000	3,890	7.6	-320	-460
40,000 to 75,000	9,070	-10.7	-1,093	-1,170†
Over 75,000	43,900	2.7	1,210	-5,100†

* 1982 dollar change in taxes "per household resulting from ERTA by income category." From a March 1984 memorandum prepared by staff of the Tax Analysis Division of the Congressional Budget Office.
† The CBO's income categories divide at $80,000 (not $75,000) for these two groups.

The Congressional Budget Office's analysis of the distributional impacts of Congressional legislative actions in 1981 and 1982 seems destined to be much discussed but seldom read.

If Lawrence S. Pratt (editorial page, May 11) had read it carefully, he would have realized that in no way did we purport to provide a forecast of changes in the distribution of tax burdens between 1981 and 1982. On the tax side, the analysis examined only one of the many sets of variables that changed between those two years, namely, those related to changes in the tax law. It isolated the initial impact using carefully described static assumptions—that is, it evaluated the impact before any behavioral response occurred. The column of figures that Mr. Pratt labels "CBO estimate" does not denote the tax liability "change from 1981" as he says, but rather it computes the difference between applying the old versus the new tax law to 1982 income levels. Mercifully, though badly misrepresenting our data, Mr. Pratt did at least note that we used static assumptions.

While the static approach has many disadvantages—carefully enumerated in our analysis—it is difficult to know where else to begin. Without a quantitative estimate of initial impacts, there is no basis for what should be a vigorous debate regarding behavioral responses and fairness. Isolating behavioral responses involves difficult statistical problems that are far from being resolved, while issues of fairness involve political value judgments that CBO is required to avoid.

Certainly, comparisons of two years of actual data shed little light on such issues. Too many things other than the tax law changed during those two years. There was a rather major recession in 1982 with effects far more complex than indicated by Mr. Pratt, and The Wall Street Journal's editorial writers in their analysis of "Tricklenomics" (April 11) seem to have forgotten it entirely. Those who use the recession to argue that there is no merit to supply-side economics are naive, but so are those who maintain that the principles of supply-side economics are confirmed by the fact that high-bracket taxpayers received a greater share of nominal income in 1982 than they did in 1981.

Aside from the effects of the recession, many taxpayers undoubtedly "gamed" the tax system between 1981 and 1982. Any sensible taxpayer would, as far as possible, have moved deductions for such things as charitable contributions backward to 1981 to take advantage of high marginal rates while moving income items, such as capital gains, forward to 1982 to take advantage of lower rates. The incentives for such maneuvering were highest in the top brackets. If taxpayers did not take advantage of such obvious incentives, they surely are not likely to have adjusted their work effort and savings behavior to changing tax burdens. But it will take many years of data to sort out the importance of such behavioral phenomena.

On a more minor point, a careful reading of our analysis would have shown Mr. Pratt that we did not use adjusted gross income to distribute taxpayers across income categories. We used something called "expanded income," which is somewhat closer to economic income than is AGI. Consequently, his table not only confused very different methodologies but also different statistical definitions. Thus his comparison between our tables and actual data is doubly meaningless—if that is logically possible.

RUDOLPH G. PENNER
Director
Congressional Budget Office
Washington

Fairness

WSJ [illegible]

Just when you thought it was safe to go out in the water . . . up pops . . . The Fairness Issue!

Like the metal shark in "Jaws," the Fairness Issue is a kind of prop, contrived by people who have a particular vision of fairness—namely redistributionism—and who, far from viewing it as an issue, have made up their minds. Their purpose, using reports by the Congressional Budget Office and the Treasury on the "Reagan" tax and budget cuts, is to spoil your fun at the economic recovery beach. Read the studies carefully, though, and you won't be scared off.

In separate articles on this page, Irving Kristol and Lawrence S. Pratt recently harpooned the CBO report. Frankly, we found CBO Director Rudolph Penner's response in defense of his underlings on our letters page yesterday rather disingenuous. Perhaps the CBO is precluded from "value judgments" and perhaps dynamic analysis is more difficult than the CBO's static analysis, as Mr. Penner says. But a lot of liberal politicians had no trouble finding in the CBO report the value judgment they were looking for, that Mr. Reagan's tax program has shifted tax burdens from the rich. And that is clearly untrue.

Mr. Penner pleads that the CBO's report was only a quantitative starting point for the debate. The "difficult" dynamic analysis of behavioral response to tax cuts was left to others. That's a little like claiming you have baked a chocolate cake but neglecting to mention that you didn't put in the chocolate. Economics to have any meaning at all has to be a behavioral science. The CBO, by skirting the question of a supply-side response to tax cuts, made possible the rapid blossoming of specious arguments that there is *no* supply-side response.

The report also ignores any "indirect" economic effects. Let's say the government cuts $100 billion from the federal budget by reducing Social Security, welfare and all other federal benefits by an average of $500 a family. And let's say that as a result of this budget balancing move, interest rates and inflation plummet, as deficit cutters say they would, raising the purchasing power of the average family by perhaps $1,000. Simple arithmetic would suggest that, on average, every family would be $500 better off. But CBO-style analysis would still have the average family $500 worse off.

Indeed the CBO urges, with gross understatement, that its analysis "be used with caution." The press gives this academic caveat all the heed a chain smoker affords the Surgeon General's warning while ripping into a pack of Camels. CBO findings are not only not qualified, but are frosted with pseudoscientific precision: "Well, Joe, if you earned $14,703, you were 482 dollars and 18 cents worse off," says the matter-of-fact voice, as if we were talking about the boiling point of water or the consequences of smoking 2.83 packs a day.

Of greater interest are the Treasury figures dealing with the tax side, outlined here recently. "Fairness" critics predicted that cutting top marginal tax rates to 50% from 70% would shift tax burdens to the poor. Yet in 1982, when such a cut took effect, individuals making $1 million or more paid 40% more than in 1981.

As some sensible letter writers note nearby, part of the surge was induced by bracket creep—taxpayers being pushed into higher brackets largely by inflation. Still, inflation slowed to 4% in 1982, and "thanks" to the recession, nominal GNP rose only 4%. Remember, it's growth in nominal income, not inflation itself, that pushes people into higher brackets. Higher prices are simply what make the process unfair. It seems very unlikely that in a recession year bracket creep accounted for a 40% rise in high-income tax payments and very likely that reduced incentives to shelter income were mainly responsible.

Likewise, there is reason to believe that once the cut in top rates passed in August 1981, people crammed income into 1982 to take advantage of the cut. Others claimed more, largely because of a cut in the capital-gains tax. But these observations do not refute the supply-side case; they enhance it, providing yet more evidence that people respond to incentives.

As Mr. Kristol observed, there is room for a legitimate debate on fairness. But, in all fairness, the debate should be based on what the real consequences of a government action are—as nearly as they can be discovered—rather than on a bunch of meaningless numbers. And if, after having discovered that lower tax rates on upper-bracket earners induce them to pay more taxes, there are still people who want to punish them with high rates, let them say so. They will have to admit that in the name of "fairness" they are willing to settle for Pyrrhic victories, but that's their business. "Jaws" makes good drama, but it is not persuasive to argue that it is good public policy.

Senator **Jepsen**. Thank you, Mr. Pratt.

Mr. Vedder, welcome back.

STATEMENT OF RICHARD K. VEDDER, PROFESSOR, OHIO UNIVERSITY, ACCOMPANIED BY LOWELL GALLAWAY, PROFESSOR, OHIO UNIVERSITY

Mr. **Vedder**. Thank you, Senator Jepsen. Glad to be back. It's a privilege to be here.

Like Mr. Pratt, I'm a humble little economist from the provinces who likes to get to come to the big city once in a while and put on my shoes to come to see you and I'd like to think that I have a sense of detachment about things, too.

I agree with everything that my colleagues on the panel say, and indeed they have stolen some of my thunder, which I had anticipated, by going last. However, let me make essentially three points.

My testimony, by the way, was coauthored by Prof. Lowell Galla-way, who is also here in the room.

First, I want to talk about fairness more specifically perhaps than the other witnesses, and there is a part of the public who believes, rightly or wrongly, that increased taxation of the rich, relative to the poor, means a fair tax system.

Now, the empirical evidence is crystal clear for those people who hold that view that the Reagan-Roth-Kemp tax bill of 1981 was a major milestone in a half a century of public policy moves in providing income quality.

Now, that statement is based not only on the data for 1981 and 1982, but on six decades of history that show a systematic tendency for the tax burdens of the rich to rise relative to the poor, when marginal tax rates are reduced for upper-income groups. That's my first point.

The second point I'd like to make this morning is that the evidence suggests that the American people are more concerned with horizontal equity—and that is to say that they believe that persons with similar incomes should pay similar amounts of income tax. The public appears to be particularly galled at the thought that some rich persons escape taxation altogether, and the 1981 tax bill in this regard was a step in the direction of alleviating that concern, as is, I might add, such legislative proposals as the Kemp-Kasten tax simplification bill.

A third point that we would like to make is that fairness itself is an elusive concept. It's difficult to define. It's impossible to objectively measure with any precision. Nonetheless, the best available evidence is that fairness cannot be increased by increasing tax rate progressivity. A "soak the rich" philosophy of taxation is not considered to be fair by the American people. The reduction in tax rates for all groups in the 1981 tax bill was viewed by the American public as an important first step in improving tax equity or fairness, contrary to the utterances of Jesse Hartdale and other politicians.

Let me elaborate briefly on each of these points. First, other witnesses and other observers, such as the distinguished syndicated columist Warren Brooks, have demonstrated that the 1982 tax reduction lowered tax payments by the relatively low-income groups but increased payments by the rich, a move in the direction of increased fairness if the view is correct that the Federal income tax previously imposed too low of a tax burden on the rich relative to the poor.

Some have criticized this evidence on the grounds that 1982 was an unusual year, with a stock market boom, a major recession, and so on. Examination of the historical evidence suggests, however, that the 1982 experience was very typical. When marginal tax rates are reduced significantly for the rich, tax payments from the rich almost invariably rise relative to tax payments from the poor.

Consider the interwar period from 1920 to 1941. In those years, the maximum marginal tax rate was lowered and raised drastically on several occasions, ranging from 24 percent in 1929 to 80 percent in 1940 and 1941. The era included high war-related rates, a period of supplyside tax rate reductions promoted by Secretary of the Treasury Mellon, and the Hoover-Roosevelt "soak the rich" tax increases of the 1930's.

Table 1 shows that in years in which the tax burden on the rich was the lowest, the proportion of total income taxes paid was the largest—more than twice as great as in the highest tax years. The evidence in table 1 is confirmed by use of a highly accepted statistical technique known as regression analysis. About 72 percent of the variation in relative tax effort by super-rich Americans is explained by variations in the marginal and average tax rates, with a strong and statistically significant negative relationship observed between the marginal tax rate and the proportion of tax paid.

The evidence suggests that high marginal tax rates of high-income Americans might satisfy the demagogic instincts of some politicians, but those rates end up placing an increasing tax burden on poorer Americans.

The experience of the interwar years is duplicated in the last quarter of a century. Take the Kennedy tax cut of 1964 and 1965. In 1963, those with $1 million or more income paid $326 million in taxes, while in 1965, they paid $603 million, and their share of the total tax burden rose significantly. Yet those high-income Americans got a generous tax cut, almost equal in percentage terms to those in lower income groups. And incidentally, a good study on this whole issue was prepared by the JEC itself in 1982. I recommend that you look at it.

The Laffer curve lives. Why? The answer is almost trivially simple. Citizens face two options: they can pay taxes or not pay taxes. The latter option can be pursued along two lines, namely, tax avoidance—which is legal—or tax evasion—which is illegal. Lowering marginal tax rates lowers the cost of paying taxes, reducing incentives to engage in either tax avoidance or tax evasion strategies. Income comes out of shelters and out of the underground economy and is taxed. Even more important, previously idle resources become productive, creating new incomes for the rich and the poor alike. If you attempt to tax the golden goose too much, it will run away.

To our second point. Survey data show that taxpayers are enraged by the fact that some rich persons do not pay taxes. In the jargon of public finance, people are concerned with horizontal equity, or the issues of whether people in similar economic circumstances pay similar amounts of taxes. It is considered unfair for some millionaires to pay hundreds of thousands of dollars in taxes while others pay nothing.

In the last few years, two significant changes in the tax code have greatly improved horizontal equity by flushing out many heretofore hidden millionaires. The first is legislation effective in 1979 sharply reducing tax rates on capital gains, and the second is legislation approved at the request of President Reagan in 1981 and initiated by Senator Roth and many others, including all three of you, I might add, who supported that legislation, lowering taxes for virtually all Americans.

Using regression analysis again, we developed a model to estimate the number of returns that would be filed by those with $1 million of income or more for the period 1970 to 1978. This model was based on personal income and time trends. Our model predicted that in 1978, there would be 2,039 returns; there were 2,035, only 4 less. The model was a very good, accurate model. Yet in 1979, our model said there ought to have been 2,474 returns, but in fact there were 3,594, 45 percent more. Why the big error? A sharp reduction in marginal tax rates of capital gains flushed well over 1,000 millionaires into the taxable economy.

Using a similar model for the period 1970 to 1981 based on levels of personal incomes, time trends, and a "dummy" variable measuring the impact of the aforementioned capital gains tax changes, we can predict over 99 percent of the variation in the number of tax returns for millionaires over time. For example, in 1981, our model predicted there would be 5,198 returns filed; in fact there were 5,280, only 82 more. But in 1982, our model said there ought to be 5,495 returns, while the actual number of returns filed was 49 percent more, 8,185. The reason is simple: The reduction in the top marginal rate from 70 to 50 percent. Some 2,690 very rich persons joined the taxpaying army, paying hundreds of millions of dollars in taxes and reducing the problem of horizontal equity.

Fairness is something that cannot be precisely measured, and indeed different people with different values have diverging views on what is fair or unfair. Professional economists or organizations—particularly, I might add, the Congressional Budget Office—have no business making statements about what is fair or unfair because there is no objective or scientific way of proving or disproving that a tax is fair or unfair. It's based on values.

Now the values of the so-called experts, including myself, shouldn't count any more in evaluating fairness than the values of millions of ordinary taxpayers with no claims of expert status. The public at large is probably the best judge as to the "fairness" of a tax.

In this regard, the nonpartisan Advisory Commission on Intergovernmental Relations has been conducting polls on tax fairess for many years. For many years, the polls were done by Opinion Research Corp. and the last one was done by the Gallup Organization.

One question that has been consistently asked is: "Which do you think is the worst tax—that is, the least fair?" Chart 1 of the prepared statement looks at changes in the proportion of the respondents thinking; the Federal income tax was the most unfair over time. During the 1970's, the proportion of the population think the Federal income tax was the most unfair tax grew nearly 2 percent each year, so that by 1981, the income tax was considered far more unfair than local property taxes, which has perennially been the most disliked tax.

Yet feelings as to the unfairness of the tax have declined slightly since the 1981 tax cut was approved, reversing a decade-long trend of increasing disenchantment. At least from the public's perspective, the 1981 tax bill seemed to be a move toward more equity, not less.

Now it is interesting to note that the rise in public perceptions of unfairness with respect to the Federal income tax in the 1970's did not occur in a period when the tax system was becoming more regressive. Indeed, as table 2 in my prepared statement suggests, the proportion of the population viewing the income tax as the most unfair tax almost doubled in a period when the share of the tax burden paid by high-income groups actually rose relative to the share of the tax burden borne by the poor. The problem with the tax system, they would suggest, is not that the rich pay too small a share of taxes; rather, the problems lie elsewhere, such as in the horizontal equity issues mentioned earlier.

Let me conclude by suggesting that the claim that the 1981 tax cut was unfair is without foundation. The 1981 legislation increased the tax burden on the rich relative to the poor, reducing vertical inequities. Horizontal inequities were reduced by increased participation in the tax system by wealthy Americans. The American public itself views the 1981 tax cut as a move toward greater equity. The fairness issue, at least as it relates to the 1981 tax cut, is no issue at all.

Thank you.

[The joint prepared statement of Mr. Vedder and Mr. Gallaway follows:]

JOINT PREPARED STATEMENT OF RICHARD K. VEDDER AND LOWELL GALLAWAY

WAS THE 1981 TAX CUT FAIR?

Thank you, Senator Jepsen, for inviting us to testify on this issue of vital national interest. This is something of a homecoming for both of us, as we both have had an enjoyable past association with the JEC as professional staff members.

There has been a growing public concern about whether the Reagan economic program, and in particular the 1981 tax bill, was "fair". We wish to make three major points with respect to this question.

First, the recent primary campaigns make it abundantly clear that some political officials and some parts of the public believe that increased taxation of the rich relative to the poor means a fairer tax system. The empirical evidence is crystal clear that persons holding that view should consider the Economic Recovery Tax Act of 1981 as a major milestone in a half century of public policy moves in providing income equality. That statement is based not only on data showing that the wealthy paid a larger proportion of the total income tax burden in 1982 than in 1981, but also on six decades of history that show a systematic tendency for the tax burden of the rich to rise relative to that of the poor when marginal tax rates are reduced for upper income groups.

Second, the evidence suggests that the American people are more concerned with horizontal equity, and strongly believe that persons with similar incomes should pay similar amounts of income tax. The public appears to be particularly galled at the thought that some rich persons escape taxation altogether. The 1981 tax bill was a step in the direction of alleviating that concern, as is such a legislative proposal as the Kemp-Kasten tax simplification bill.

Third, "fairness" is an elusive concept to define and impossible to objectively measure with any precision. Nonetheless, the best available evidence is that fairness cannot be increased by increasing tax rate progressivity. A "soak the rich" philosophy of taxation is not considered to be fair by the American people. The reduction in tax rates for all groups in the 1981 tax bill was viewed by the American public as an important first step in improving tax equity or fairness, contrary to the utterances of Jesse Hartdale and other politicians.

Marginal Tax Reductions and the Tax Burden: Historical Evidence

Let me elaborate briefly on each of these points. First, other witnesses and other observers such as the distinguished syndicated columnist Warren Brookes have demonstrated that the 1982 tax reduction lowered tax payments by the relatively low income groups but increased payments by the rich, a move in the direction of increased fairness if the view is correct that the federal income tax previously imposed too low of a tax burden on the rich relative to the poor.

Some have criticized this evidence on the grounds that 1982 was an unusual year, with a stock market boom, a major recession, and so on. Examination of the historical evidence suggests, however, that the 1982 experience was very typical. When marginal tax rates are reduced significantly for the rich, tax payments from the rich almost invariably rise relative to tax payments from the poor.

Consider the interwar period from 1920 to 1941. In those years, the maximum marginal tax rate was lowered and raised drastically on several occasions, ranging from 24 percent in 1929 to 80 percent in 1940 and 1941. The era included high war-related rates, a period of supply side tax rate reductions promoted by Secretary of the Treasury Mellon, and the Hoover-Roosevelt "soak the rich" tax increases of the Thirties.

TABLE ONE

Tax Rates and Share of Total Tax Burden Borne by Super Rich, 1920-41#

Period	Median Effective Tax Rate+	Median Marginal Tax Rate+	Percent of Total Taxes Paid by the Super Rich#
5 Lowest Tax Years*	16.19	25.0	11.18%
12 Middle Burden Tax Years*	39.33	63.0	6.30
5 Highest Tax Years*	69.71	78.0	4.58

#"Super Rich" includes those reporting incomes of more than $1,000,000 a year.

*As measured by the effective tax rate, which is total tax payments divided by total reported income.

+Rate applying to those with incomes in excess of $1,000,000 a year.

Table I shows that in years in which the tax burden on the rich was the lowest, the proportion of total income taxes paid was the largest -- more than twice as great as in the highest tax years. The evidence in Table I is confirmed by use of a highly accepted statistical technique known as regression analysis. About 72 percent of the variation in relative tax effort by super rich Americans is explained by variations in the marginal and average tax rates, with a strong and statistically significant negative relationship observed between the marginal tax rate and the proportion of tax paid.

The evidence suggests that high marginal tax rates of high income Americans might satisfy the demagogic instincts of some politicians, but those rates end up placing an increasing tax burden on poorer Americans.

The experience of the interwar years is duplicated in the last quarter of a century. Take the Kennedy tax cut of 1964 and 1965. In 1963, those with $1,000,000 or more income paid $326 million in taxes, while in 1965 they paid

$603 million, and their share of the total tax burden rose significantly. Yet those high income Americans got a generous tax cut, almost equal in percentage terms to those in lower income groups. More details on this tax cut are provided in an excellent 1982 staff study prepared for your committee, and I recommend you look at it.

The Laffer curve lives! Why? The answer is almost trivially simple. Citizens face two options: they can pay taxes or not pay taxes. The latter option can be pursued along two lines, namely tax avoidance (which is legal) or tax evasion (which is illegal.) Lowering marginal tax rates lowers the cost of paying taxes, reducing incentives to engage in either tax avoidance or tax evasion strategies. Income comes out of shelters and out of the underground economy and is taxed. If you attempt to tax the Golden Goose too much, it will run away.

Flushing the Millionaires into the Tax Economy: The 1981 Tax Cut

To our second point. Survey data show that taxpayers are enraged by the fact that some rich persons do not pay taxes. In the jargon of public finance, people are concerned with horizontal equity, or the issues of whether people in similar economic circumstances pay similar amounts of taxes. It is considered unfair for some millionaires to pay hundreds of thousands of dollars in taxes while others pay nothing.

In the last few years two significant changes in the tax code have greatly improved horizontal equity by flushing out many heretofore hidden millionaires. The first is legislation effective in 1979 sharply reducing tax rates on capital gains, and the second is legislation approved at the request of President Reagan in 1981 lowering taxes for virtually all Americans.

Using regression analysis again, we developed a model based on changing personal income levels and time trends that can explain almost 94 percent of the variation in the number of income tax returns filed by persons with more than $1,000,000 in income for the period 1970 to 1978. In 1978, for example, there were 2,039 returns filed by those making $1,000,000 or more annually in income, while our model predictad 2,035 returns, only four less. Yet in 1979 our model says there should have been 2,474 returns -- but in fact there were 3,594, 45 percent more. Why the big error? A sharp reduction in marginal tax rates of capital gains (from 49 to 28 percent) flushed well over a thousand millionaires into the taxable economy.

Using a similar model for the period 1970 to 1981 based on levels of personal incomes, time trends, and a "dummy" variable measuring the impact of the aforementioned capital gains tax changes, we can predict over 99 percent of the variation in the number of tax returns over time, and the model is otherwise extremely robust statistically. In 1981, our model predicted 5,198 returns would be filed by those with over $1,000,000 in income, while in fact 5,280 were filed, only 82 more. However, in 1982, the same model predicts 5,495 returns, while the actual number of returns filed was 49 percent larger, 8,185. The reason is simple: the reduction in the top marginal rate from 70 to 50 percent. Some 2,690 very rich persons joined the taxpaying army,paying hundreds of millions of dollars in taxes and reducing the problem of horizontal equity.

Fairness and the 1981 Tax Cut: Some Evidence from the People

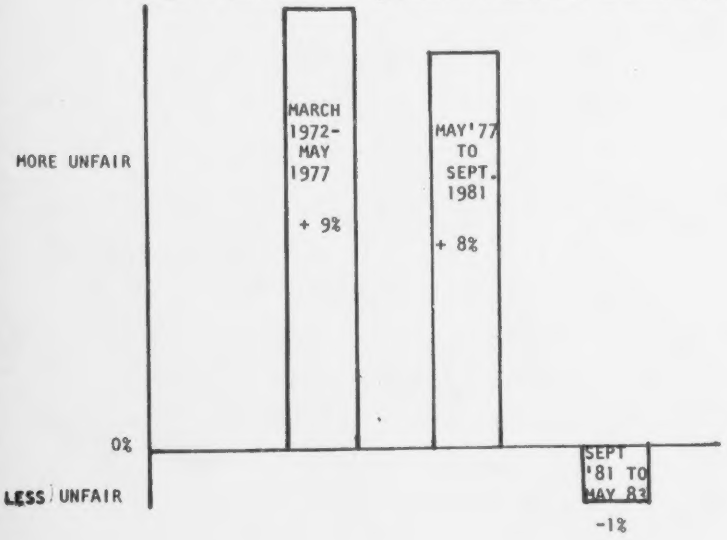
Fairness is something that cannot be precisely measured, and indeed different people, with different value systems, have diverging views on what is fair or unfair. Professional economists or organizations like the Congressional Budget Office cannot in any objective, scientific way, "prove" or disprove that any tax is fair or unfair. The values of the so-called experts, including myself, should count no more in evaluating fairness than the values of millions of ordinary taxpayers with no claims of expert status. The public at large is probably the best judge as to the "fairness" of a tax.

In this regards, the nonpartisan Advisory Commission on Intergovernmental Relations (ACIR) has been conducting polls on tax fairness for many years. For many years, the polls were done by Opinion Research Corporation, although the latest poll was conducted by the Gallup Organization.

One question consistently asked is: "Which do you think is the worst tax - that is, the least fair?" Chart One looks at changes in the proportion of the respondents thinking the federal income tax was the most unfair over time. During the Seventies, the proportion of the population thinking the federal income tax was the most unfair tax grew nearly two percent each year, so that by 1981 the income tax was considered far more unfair than local property taxes, perennially the most disliked tax. Yet feelings as to the unfairness of the tax have declined slightly since the 1981 tax cut was approved, reversing a decade long trend of increasing disenchantment. At least from the public's perspective, the 1981 tax bill seemed to be a move towards more equity, not less.

CHART ONE

Change in Percent Viewing Federal Income Tax As Most Unfair Tax. 1972-83



It is interesting to note that the rise in public perceptions of unfairness with respect to the federal income tax did not occur in a period when the tax system was becoming more regressive. Indeed, as Table 2 suggests, the proportion of the population viewing the income tax as the most unfair tax almost doubled in a period when the share of the tax burden paid by high income groups actually rose relative to the share of the tax burden borne by the poor. The problem with the tax system, that would suggest, is not that the rich pay too small a share of taxes. Rather, the problems lie elsewhere, such as in the horizontal equity issues mentioned earlier.

TABLE TWO

Fairness and Tax Burdens, 1972 and 1981

	1972	1981
Percent Viewing Federal Income Tax As Most Unfair Tax	19%	36%
Percent of Income Taxes Paid by Top 10 Percent of Income Recipients	43.68	44.06
Percent of Income Taxes Paid by Bottom 20 Percent of Income Recipients	2.67	1.99
Progressivity Index: Ratio, Tax Payments of Top 10 Percent To Tax Payments of Bottom 20 Percent	16.7	22.1

SOURCES: Internal Revenue Service, Advisory Commission on Intergovernmental Relations

Conclusions

The claim that the 1981 tax cut was unfair is without foundation. The 1981 legislation increased the tax burden on the rich relative to the poor, reducing vertical inequities. Horizontal inequities were reduced by increased participation in the tax system by wealthy Americans. The American public itself views the 1981 tax cut as a move towards greater equity. The fairness issue, at least as it relates to the 1981 tax cut, is no issue at all.

Senator **Jepsen**. I thank you.

The critics of the current administration assert that its policies have resulted in a massive redistribution of income from the poor to the rich. Is this view consistent with the results of the tax cuts and the dramatically lower rate of inflation after 1981? Does anybody on the panel care to comment on that?

Mr. **Roberts**. I think, Mr. Chairman, that the charge is obviously false. It's contradicted by not only all the evidence you have heard this morning but the rest that hasn't been presented. There's no basis in fact for that charge.

Senator **Jepsen**. Mr. Pratt, in your statement, you refer to a recent Congressional Budget Office staff study on recent tax changes. You also note its use of static estimates even though the data on actual payments in 1982 were available.

In addition, Mr. Rahn, in your prepared statement, you say for income categories above $40,000 the CBO projected a $23 billion shortfall. The actual results, however, show that tax revenues from this group actually rose by approximately $4.5 billion.

Are you saying then that the CBO's projection of tax revenues derived from this income group was off by $27.5 billion?

Mr. **Rahn**. That's quite right, and as I pointed out earlier, I think the CBO study was a dishonest study, particularly since the data was already in and the fact that they just totally ignored the incentive effects to work, save, and invest made by the tax rate reductions. Essentially, they argue that Reaganomics failed by ignoring the effects of the Reagan program, and I just find that basically unconscionable for a group of professional economists to do that and I would encourage you to——

Mr. **Roberts**. Change the Director.

Mr. **Rahn**. That was Mr. Roberts' statement, not mine, but I think your displeasure should be made known to the CBO that that kind of study should not be allowed.

Senator **Symms**. If the chairman would allow me to ask a question, do you think they did this because they are just incompetent or because they are trying to mislead the public?

Mr. **Rahn**. Senator Symms, I really don't know what the motivation was. I could guess the motivation, but I have never looked at them as being incompetent. I do not know what the direct motivation was there, but it's clearly something we shouldn't tolerate.

Senator **Jepsen**. Mr. Pratt, we might examine this going back to your statement. From your statement, could we assume that you consider their study to be biased and unreliable?

Mr. **Pratt**. The title is "The Effects of the ERTA Tax Cut," but there were three studies in fact. There was one of the ERTA cut, one of the TEFRA, and one of the effects of domestic spending programs. I only looked at the ERTA side of it because, for one thing, the actual data we had on TEFRA didn't apply to the 1982 tax payments.

I don't know why they did it. If I had to guess, I'd say that somebody said that this is the result we want. That's very common in these kind of situations. It was a static analysis. They acknowledge that it was a static analysis. Mr. Penner wrote the Wall Street Journal after my article appeared saying it was a static analysis and it was only the beginning of finding out what actually happened. There were no such letters when the New York Times was citing this as proof that the rich got richer and the poor got poorer. So from that, I have to conclude there was a bias.

Senator Jepsen. OK. Well, our purpose today is not necessarily to discuss the veracity or credibility of the CBO, except to point out that, in fact, information that will be used and quoted from their studies and reports in 1984 will be conveyed to the American people. Therefore, the fact that the one study Mr. Rahn pointed out that the projection of tax revenues was off by $27.5 billion, and the fact in another study made by the Congressional Budget Office staff they used static estimates even though there was actual data on actual payments available, are relevant. There seems to be much public misunderstanding about the relative share of taxes paid by various income groups. It is talked about and will be talked about much during the balance of 1984.

Do the wealthy now pay a smaller share of their incomes in taxes than do middle- and low-income taxpayers and has this relationship been stable over the years? Mr. Gwartney, do you want to answer that?

Mr. Gwartney. I'm not sure I quite understand the question.

Senator Jepsen. Do the wealthy now pay a smaller share of their income in taxes than do middle- and lower-income taxpayers?

Mr. Gwartney. My answer to that question is obviously no, that they pay a larger share of their income than low- and middle-income taxpayers and they have for some time. I think the more relevant consideration is what share of revenues you collect from high-income people under different rate structures, and the sort of layman's seat-of-the-pants-type view is that obviously if you raise the rates of the wealthy, you will gather more revenue from them, and that's not true. The reason why it's not true is for the same reason it doesn't make any sense for General Motors to try to sell their cars for $50,000. Not many people buy them. And what happens when you continue raising rates in the upper brackets, is that people have options, as several members of this panel pointed out, to paying those high rates. They have legal options. One of the options, of course, is to not earn income. They opt out of the labor force and do other things, spend more time on vacation, less overtime, and all those kind of things, but they have a number of other options as well, such as organizing their financial affairs a little bit differently.

Someone said that they thought the very best tax shelter or tax avoidance technique is you pick out what you like to do and then you go into that business. Therefore, it means what you like to do, the expenditures for that sort of thing are tax deductible for you. If you like to ski, you become a ski instructor, not full time. You stay a doctor or lawyer or whatever, but you become a part-time ski instructor on the side. If you like to drive cars, you go into some type of distributional service where you can deduct off $15,000 or $20,000 automobiles from the cost of your services.

Now let me make one point with regard to this because I think this is critically important and it has not come out to the extent that I think it's important to this panel. That is, some people have the view that these tax avoidance techniques or tax shelter techniques involve simply closing up a few loopholes or something of this sort. It's not true. They involve literally thousands of different kinds of techniques that are encouraged by how high or how low the marginal tax structure rates are.

So what happens is when you reduce those rates in the upper income brackets, you collect more revenues from them. The incentive structures I covered in my introductory remarks very clearly indicate that that would be the case for a proportional tax reduction. The data for even that top 50 percent—which, by the way, in exhibit 5, the reason I chose the top 1.36 percent of taxpayers is that is roughly the percent of people who would pay the above 50 percent marginal rate in 1981. So when we reduce those rates suddenly on nonpersonal service income, in some cases by as much as from 70 percent to 50 percent, we gathered more revenue from those people, both in dollar terms and as a percentage of the total revenue.

So I think what the 1981–82 cut indicates, as well as analyses in more detail that I referred to that Jim Long and I have done, is if you want to gather more revenues from high income people, what you need to do is reduce those top rates even more. I think you could reduce the top rates to the neighborhood of 30 percent and you would find that high income people would pay a higher percentage of the total taxes and that you would gather more revenue from them at those lower rates than what you currently have.

Senator Jepsen. Senator Roth.

Senator Roth. Thank you, Mr. Chairman.

I'd like to go back to the question of what we should do with the tax structure. I take it from what you just said, Mr. Gwartney, that you don't think that the so-called tax package that we have in conference right now is going to end tax shelters.

Mr. Gwartney. Absolutely not.

Senator Roth. I'm not an economist and I'm just a plain politician. The thing that bothers me so much is that, as I understand your testimony today, all of it is very simple, but it's very difficult to get through because of these charges of unfairness. But if I understand your testimony, what you're saying is that the consequence of the tax cut of 1981 is that the wealthy are in fact both percentagewise and actual dollars paying more taxes. Is that correct?

Mr. Roberts. Yes.

Mr. Rahn. Correct.

Mr. Gwartney. Right.

Mr. Vedder. Right.

Mr. Pratt. Yes.

Senator Roth. And the negative side or the other side of that is that the poor or less affluent are paying both less taxes percentagewise and they are paying less taxes dollarwise.

Mr. Gwartney. That's correct.

Mr. Rahn. Right.

Senator Roth. Why is that so hard to get through? It seems to me even I can understand that. Why is that so hard to get across, because I think we have to face the fact that the American people have been sold a bill of goods that the very opposite has happened. Would you agree with that?

Mr. Vedder. That's right.

Mr. Rahn. Yes.

Mr. Gwartney. Yes.

Mr. Vedder. Part of the answer, Senator Roth, is right over there [indicating] in your own organization—not yours personally, but the

U.S. Congress is subsidizing an organization that is spreading malicious lies that are completely without factual foundation about this in the form of this chart and other forms and in so-called studies that are based on totally erroneous assumptions about human behavior.

Senator ROTH. I'd like to go to the economic model in a moment, but let me just, if I might—these figures that you're citing showing the conclusions that we just went over, can those be challenged? Can other figures be carted out showing otherwise or is there any question, any basis of saying that the rich in fact did not pay more? Are those figures that you're basing your conclusions on beyond challenge?

Mr. ROBERTS. They are the figures of the Internal Revenue Service.

Senator ROTH. And they are published figures?

Mr. ROBERTS. If the Internal Revenue Service decided they wanted to somehow revise their figures, the way the Federal Reserve does——

Mr. PRATT. Senator Roth, the challenges to the numbers presented here are that they are just 1 year—1982 was a year of recession. 1982 was a year when the stock market went way down and went way up. The rate of change of prices decreased. The upshot is that it's too soon to tell, maybe. Certainly, by the time 1984 returns are analyzed, which because the 1984 returns won't be filed until next April—1985—won't be analyzed for another 9 or 10 months after that—by then, we should have a much better picture. But as all of us today have pointed out, the data that we have, the 1982 returns, and the trend of the "other" component in Treasury receipts, indicate that there has been a surge in tax payments by those with high incomes, high property income particularly. If the data had been the other way, I think we'd hear more about them.

Senator ROTH. In other words, the only evidence that's available at this time confirms the conclusions that were drawn?

Mr. ROBERTS. Yes; and so does all the evidence from all past occasions of similar tax cuts.

This is not a new pattern. This is a pattern that occurs every time the top rates are cut.

Senator ROTH. The same thing happened in the so-called Kennedy round?

Mr. ROBERTS. That's right, and also in the Mellon period.

Senator ROTH. Couldn't you have made the same false allegations against Kennedy that that benefited the rich? I mean, if you accept it for this round, wouldn't it be equally applicable for the Kennedy round?

Mr. ROBERTS. Fortunately for President Kennedy, at that time the Congressional Budget Office did not exist. That was a mistake of the mid-1970's.

Senator ROTH. Let me ask you this question: Is there anywhere an economic model that's not static and takes into consideration some of these other factors that you gentlemen agree is a good economic model?

Mr. GWARTNEY. You're talking about a macroeconomic model?

Senator ROTH. Macroeconomic, yes.

Mr. RAHN. Well, all the models involve a good deal of judgment in terms of certain assumptions, but you might take a look at the record of the economic forecasters particularly over the last couple years, and I think that you will find those forecasters with the supply-side orientation, such as the U.S. Chamber, have been very close to the mark. I realize that it is self-serving, but it's also true. As opposed to the Keynesians who are claiming the recovery could not take place and then they said it would be an anemic recovery or one with a rapid inflation. They have been consistently wrong. If we could start rejecting those people who have been consistently wrong and start looking at the ones that have had a little better track records—the science of economic knowledge building is still probably more an art than a science, but clearly in the last couple years to differentiate those who have done a rather poor job from those who have done a much better job.

Senator **Roth**. I'd like to switch ground just slightly now. I notice in most of your testimony a great deal of confidence in the economic recovery and yet that seems again to be the opposite of what one reads in the press, opposite what one hears even on Wall Street, and so forth.

Let me ask you, do you see the economic recovery as sound, as continuing, or do you think it's a very fragile thing that can collapse at any instant? If you feel it's strong, why is there this extremely nervous perception abroad that it's temporary in nature?

Mr. **Rahn**. Since I have been one of the more optimistic ones predicting a strong recovery for the last 2 years, all the evidence is that this is a very strong recovery. It is very well balanced. The great increase in plant and equipment spending that I mentioned has led to higher levels of productivity than most people had forecast. If you look at the amount of job creation, there's no period when we've ever had this kind of increase in job creation.

Now, of course, the recovery could be aborted and that could only be done by the Federal Reserve and that is a constant worry among all of us who watch and make policy recommendations concerning the economy about the erratic Federal Reserve behavior. But in the absence of a major mistake by the Federal Reserve, this recovery clearly ought to go for the next couple years at a strong level.

Now you're absolutely right about the bad press. I'm astounded when I often read the Washington Post of what their analysis is versus what the facts are. But if you look at what they have been saying for the last several years—and there are a number of politicians and news organizations that seem to have a vested interest in bad news and the failure of our type of free enterprise society. Those of us who believe in the importance of higher real economic growth and personal freedom, I think have to speak more loudly against these people who do not seem to have the same kind of respect for the Constitution and the importance of increasing real per capita incomes of most of us in the room.

Senator **Roth**. Now one of the criticisms one hears or one of the comments one constantly reads is that this recovery is not based on Reaganomics, the changes that he's brought about, but in fact we still have Keynesian economics in effect, that this is just an outflow of the constant deficit. How do you answer that?

Mr. **Rahn**. I think Mr. Roberts did a nice article about that the other day.

Mr. **Roberts**. Senator Roth, the evidence shows clearly that the growth in consumption has lagged the growth in the real gross national product and that this is not a consumption-led recovery.

The evidence also shows a very unusual feature of this recovery, and that is that the contribution of fixed business investment to GNP growth is three times the average contribution which has characterized all recovery in the postwar period.

The data on this recovery is not based on any model or theory. It's based on the evidence that has been thrown up by the economy itself, and the data show clearly that it is not a consumption-led Keynesian recovery.

The reason I think, Senator Roth, that the strong recovery has such a bad press is that the entire forecasting establishment predicted that there would be no recovery and therefore they're very embarrassed to have been so wrong in their forecast and they are trying to pretend that it's not really here and it's going to go away any moment. They are basically people who were completely wrong and who are trying to cover up the fact that they cannot forecast.

Senator ROTH. Could I ask one more question?

Senator JEPSEN. Sure.

Senator ROTH. As you know, we have a tax package before us. There's already a lot of talk about what's going to happen next year, some talk about reform, but even more talk that once we get through the election, what we're really going to have to do is raise taxes substantially to reduce the deficit.

What I would like to ask you is a twofold question. No. 1, is that the kind of medicine that the economic recovery needs, a tax increase, in whatever form? And second, could you briefly say if we are going to have tax reform, what are the criteria you would use in bringing about that reform or that change?

Mr. ROBERTS. Senator Roth, I think that the talk about higher taxes is probably hurting the recovery because it creates so much uncertainty for decisionmakers. They are not certain which taxes and when. If taxes are raised by any substantial amount, it will definitely hurt the recovery, and this is something that every economic model would predict, not just a supplyside one. It is the consensus of all economic models that tax increases retard economic growth. There's no theory that says tax increases help economic growth.

I think the talk about the tax increase, as well as the reason for one, is largely political. It is an effort to pretend that the Reagan tax cuts were not successful. It is, in my view, entirely a political operation. It has nothing to do with economics, with the need of the economy, but it is an effort to paint a highly successful program as unsuccessful, and therefore we must backpedal and back away from it. That is all the tax increase talk is about.

Now to answer your other question, if there is an opportunity for a major tax reform along supply-side lines, then seize it and certainly you might make all efforts to change this rather silly tax increase before the Congress now into a major reform that would broaden the base in exchange for sharply lower rates. If we could have a further supply-side tax reform, then we could expect the high growth rates which have characterized the economy recently, and which have been noninflationary to continue for a long time.

Mr. RAHN. I'd like to add just a couple comments to Mr. Roberts' remarks which I fully concur with. Again, I am hopeful that after the election period when much of the political demagoguery goes away, that people will start looking at the deficits in a far more dispassionate way than they have been and see how rapidly they are coming down as a result of economic growth.

Now it is true that the Congress needs to do more on the spending side, but it is also true that right now tax revenues are increasing at a far faster rate than are Government expenditures. Hence, you do have the real drop in deficit, particularly when you add in the State and local government surpluses. If you look at the governmental sector deficit, it is getting down to numbers that are very close to what they were in the mid-1970's, and we lived with that. Not that I'm advocating we live with high deficits. We need to do more on the spending side, but the evidence, as Craig Roberts and many people here have stated time and time again, is overwhelming that major tax increases will retard economic growth, if not bring on a major recession, which causes higher spending rather than lower, and that over time, further reductions in those taxes that particularly provide disincentives to work, saving and investment will bring greater degrees of economic prosperity and well being to our people.

Mr. ROBERTS. Senator Roth, I'd like to say that the deficit is totally a red herring and these predictions of deficits have proven to be even more inaccurate than the Congressional Budget Office's predictions of tax cut gains.

If you look at the budget of the U.S. Government for fiscal year 1984, that is the budget that was issued officially by the Government for the current fiscal year, the prediction was that the deficit for this current fiscal year would be $231 billion. Well, it's currently running in the $160 to $170 billion range, so here we have the deficit actually coming in $60 to $70 billion below predictions for the year.

If the recovery is allowed to continue by the Federal Reserve Board—and that is not a certain fact—but if it is allowed to continue, then you will see that the deficit, when offset by the surpluses of State and local government budgets, is no longer an economic problem.

The only way the deficit can become an economic problem is if the recovery is seriously slowed or aborted. If the recovery is slowed or aborted by the Federal Reserve or by tax increases or by a combination of both, then the deficit will rise. But the current deficit is falling. It's falling rapidly, and is much below OMB's prediction for this year's budget of $231 billion. Obviously, this is a forecasting error of enormous magnitude.

Senator SYMMS. What do you think it will end up at?

Mr. ROBERTS. Well, if it's not aborted, I think that the deficit for the year will probably come in around $165 billion, but that it will be falling such that by the time you hit the last part of the year it will be running about $130 billion on an annual rate.

Now if you add to that the surpluses in State and local government budgets which are around $60 billion, then you do not have the Government presence in financial markets on any scale that would disturb anything.

Senator SYMMS. Senator Boschwitz recently wrote an article which was in the New York Times about 2 or 3 weeks ago that I thought was very good, where he pointed out that the same people that predicted a balanced budget in 1984 are now predicting a $200 billion deficit. He thinks it looks like they may be that far off again and there may be a chance that it could, under just a recovery, just completely be diminished to nonsignificance.

Mr. **Roberts.** Yes. If you compare the current budget projections of the Office of Management and Budget to the ones they made a year ago, they've already had to reduce these projections by an average of 25 percent, and for what they call the out-years, by a factor of one-third.

Senator **Symms.** Well, I'm interested in this chart that's up on the wall, Mr. Chairman, and the comments that were made. Mr. Vedder, you made some pretty strong statements there and I appreciate that, but when you made those statements about the so-called disinformation by the CBO I am reminded of articles and speeches that Arnold Bourchagrave gives about disinformation on the part of the Soviets in other matters. One that particularly comes to mind is how our own CIA seems to try to cover up the fact that there's a definite connection between the attempted assassination of the Pope and the Bulgarians and the KGB, and yet our CIA wants to cover that up so that we don't have the appearance that there's a difference between us and the Soviets.

Do you see any parallel there?

Mr. **Vedder.** Well, I must admit I wasn't prepared for that question.

Senator **Symms.** But the taxpayers are paying for this nonsense over here and that gives fuel to the fire of portions of the Western media in the free press who don't believe in supply-side economics and are anticapitalistic in their mentality anyway.

Mr. **Vedder.** Right.

Senator **Symms.** So they take that and run with it.

Mr. **Vedder.** Well, I'm sorry I was a little strong on the CBO, Senator.

Senator **Symms.** Don't apologize.

Mr. **Vedder.** I know I don't have to apologize to you, however, I once worked in the same building with the CBO and I sort of got a feeling that there was something less than total objectivity in the preparation of some studies. But aside from that, it seems to me that if a young assistant professor at my university had come in with a study like this and came up for tenure and he says, "I need to be given tenure," I would say, "No, you don't know anything about economics." To prepare a study that ignored the basic assumptions of human behavior that people respond to changes in relative price, which is essentially what we are talking about here, to ignore that among professional economists is totally unconscionable. That is like trying to repeal the law of demand, and that is essentially to go beyond the pale of what is acceptable.

Senator **Symms.** Congress has tried to do that, too. It didn't work.

Mr. **Vedder.** I noticed, yes.

Senator **Symms.** Mr. Rahn.

Mr. **Rahn.** Well, I would just totally agree with Mr. Vedder. What it is, is equivalent to repealing the law of supply and demand. You are saying that people do not respond to changes in price.

Senator **Symms.** The late Keith Sebelius was a very dear friend of mine, a Congressman from Kansas. When we were in the House together we went through these drills of wage and price controls and we were always in opposition to it. At the time something that was very controversial was the skyrocketing price of beef in the store and there was a great uproar on the floor. They were extending it and we were opposing the extension of wage and price control authority. Mr. Sebelius offered an amendment to the bill which changed the gestation period of a cow from 9 months to 7 so that they could have the calves faster, and lower the price for the Congress. And he made his point, but we still lost the vote because there was such a strong anticapitalistic mentality in the country, but I think it's gotten better since those days with Ronald Reagan's Presidency.

Now, I want to ask three specific questions. One is, there's a lot of talk about broadening the base and lowering tax rates and I happen to be someone who believes that where you tax people, whether the tax hits consumption or production, has a big overall impact, as well as what the rate of taxation is. So the Kemp-Kasten bill is talked about a lot and there's the Bradley-Gephardt plan.

There's another plan that was prepared by the Hoover Institute of Stanford, the Hall-Rabushka plan. Would each one of you tell me which one of these plans, if you had your druthers, that you would like to see pass, or are you familiar enough with them?

Mr. ROBERTS. I would like to say that all three plans show the ascendency of supply-side thinking because that is the basic framework for all three plans. I think that's significant, Senator Symms, because Bradley and Gephardt are liberal Members of the Congress and to see them with a supply-side framework for their own tax program is, I think, significant.

Senator SYMMS. Do you think the Hall-Rabushka plan of the Hoover Institution is superior to the other plans?

Mr. ROBERTS. I think if you could get the Hall-Rabushka plan or the Kemp-Kasten plan, you would have a fundamental improvement in the tax system of the United States that would have lasting effects for decades and I think these would be a wonderful contribution to the welfare of everyone in the country.

Senator SYMMS. How does the Kemp-Kasten plan affect the farmers, though?

Mr. ROBERTS. What do you mean?

Senator SYMMS. A small business farmer, a farmer who's not incorporated and has to have business deductions and so forth in order to survive, where his gross income and his net income would be far and away a different subject.

Mr. ROBERTS. Well, Senator Symms, I'd have to study that particular question in detail. I would say that it's likely to affect the farmer in many ways, many that would not maybe be obvious to him, and it would come from having created a better and far superior economic environment and, of course, the general economic environment is one of the main features which determines the success of any kind of business venture.

Senator SYMMS. Well, what about—I've been told by some people that there is a bias against the West and the Southwest where you have oil depletion allowances, mineral depletion allowances, timber capital gains taxes, and agricultural taxing of many business agricultural deductions and so forth that are taken.

Would there be, in your opinion, any bias against the production areas of raw materials in the country with a flat rate income tax or the Kemp-Kasten bill, for example?

Mr. ROBERTS. I don't think about them in that way. What you're doing is that you're creating a low and uniform tax rate which offers of course, enormous incentives for investment without the distortions that are inflicted on investment by having a different tax situation for every kind of investment. If you have a different tax situation for every kind of investment, then you get people making investment decisions for tax reasons rather than for economic or investment reasons. So the whole notion of these three approaches——

Senator SYMMS. Well, I would be against the Western people stopping investment in the production of minerals, timber or oil and gas.

Mr. ROBERTS. Why would they if they find that the tax paid on their profits is lower? I mean why should they? You can't think about this in terms of the distributional gains and losses in tax subsidies because what you're going for is a far superior environment, and you hope that in general the broadening of the base is offset by the lowering of the rates. If there are some special cases in which this does not happen, you just have to go with it.

Senator SYMMS. The problem is, I don't have to worry about it either except that if I want to get reelected in 1986, and if I have all the major production companies in my State down on this idea that I'm promoting, it makes it a little difficult if the word is out that Symms is going to raise your taxes in this big effort for flat rate income taxes. Now Peter Grace said before this committee that 90 percent of the income available to the Federal Government comes from people who earn $35,000 a year or less, and my great fear about tax reform is when politicians talk about tax reform it's because they don't have the guts to talk about spending reform. With a 25-percent spending rate of the GNP and a 19-percent revenue flow of the GNP to the Treasury, unless growth in the economy gets up enough so that the revenue equals the spending, just pure growth, something has to be done on the spending side.

Now I think all of you are opposed to doing away with indexing. Is that correct?

Mr. ROBERTS. Tax indexing.

Senator SYMMS. Tax indexing.

Mr. RAHN. Yes.

Mr. GWARTNEY. Yes.

Senator SYMMS. Now my personal CPA is not an economist but he's an accountant, and he says that those of us that argue that we should keep indexing at all costs are making a grievous mistake. He says, "What you should argue is to do away with all indexing of the spending side and the Tax Code at the same time and your consumers and taxpayers will benefit from that because the money that we don't raise taxes for we're borrowing or we're printing it or counterfeiting the currency, so the taxpayer has to pay for it either way." And he makes that argument.

What do you say back, Mr. Rahn?

Mr. RAHN. Since I've watched the behavior of you and your colleagues for a number of years, that assertion assumes that you would not go ahead and increase payments to Social Security recipients or medicare recipients or the other people that have indexed programs, and I know that you and Senator Jepsen might well vote against having big increases in those programs in the name of fiscal responsibility, but, unfortunately, from what I've noticed of the behavior of many of your colleagues, I think that is unlikely to occur.

In addition, getting rid of tax indexing of course hurts the low and middle income people and you have that constant increase in revenue as a percentage of GNP going to the Federal Government and, again, if you look at history, we find that the Congress has always managed to increase spending faster than revenue and any time we have attempted to go ahead and bring revenue up to spending somehow spending has gotten ahead.

Senator SYMMS. Right. He's making the argument, though, that the budget is balanced. He's looking at it as an accountant.

Mr. RAHN. Those fellows who did that [indicating the CBO chart] are accountants, too.

Senator SYMMS. He said that the budget is balanced and you're balancing it by either borrowing or printing money. If you could get all 92 indexed programs frozen in place then it would be a fair tradeoff, then you would actually leave more money in the hands of the private sector to build and go with.

Mr. RAHN. First of all, are you going to freeze those programs?

Senator SYMMS. The answer is no, of course.

Mr. ROBERTS. That would depend on the inflation rate and the Federal Reserve over whom—as far as I can tell—nobody has any control.

Senator SYMMS. Mr. Pratt.

Mr. PRATT. I would say I agree with your accountant in that if I had to make a choice of which I would think is better, if I had to give up indexing, I'd rather do it on both sides or I'd even trade the indexing of the taxes for the deindexing of the spending. I don't think there's a serious proposal for this anywhere.

Senator SYMMS. Well, it's interesting.

Mr. PRATT. That's what I say. I would favor it because it would create an enormous constituency who would be aghast at inflation.

Senator SYMMS. Well, it's interesting that I tried it on the Senate Finance Committee and didn't get any takers.

Mr. PRATT. I don't imagine so.

Mr. ROBERTS. That surprises me. I would think that you would, Senator, because I think that Mr. Rahn's point was that if you take away the automatic indexing of benefits, you will simply replace them with legislated increases in benefits. I'm surprised Congress ever gave up the right to legislate Social Security benefits and instead replaced them with an automatic cost-of-living adjustment, because you can't go out and tell them, "I've raised your benefits," because it was done automatically.

Senator SYMMS. But if we could get this idea of reducing the tax rates popular, we could do that every year also. We could have a 5-percent reduction in rates every year and I have said to a lot of people that probably if we would just repeal the taxes on dividends and double taxation and the taxes on interest, if we had done that in 1981 along with reducing all the rates down to where the highest rate was 50 percent, and then just start reducing all tax rates at 5 and 10 percent a year and just keep on going and not touch the rest of the Tax Code, we'd have a lot less confusion—you know, we've just got chaos out there in the business community because we change the Tax Code every year. It's like being a roller ball player.

Mr. RAHN. You have made a key point there and I think one of the best things Congress could do in terms of taxes is take a long vacation.

Senator SYMMS. Absolutely. If the Senate Finance wouldn't meet for 5 years and the House committee wouldn't meet——

Mr. RAHN. Because right now we know businessmen are reluctant to invest because you put the ACRS in in 1981 and you took a big hunk of it back in 1982 and so the investors all assume the worst is going to happen to them. Hence, we have lower levels of investment than we would have had.

Senator SYMMS. But on the other side of this, if we could get spending under control, then there wouldn't be so much pressure to raise taxes. I have felt that the supply-side economic theory that supposedly President Reagan came into town with, we only got about a third of it put into effect and two-thirds of it is still yet to be put into effect, and the first thing that would have been helpful is if we would have knocked out the increases in spending really dramatically in 1981.

Mr. RAHN. Well, you see how well it works then. Already we have the highest growth rate of any economy in the world with only one-third of it in effect. Just think if we had the other two-thirds.

Senator SYMMS. Did you want to make a comment, Mr. Vedder?

Mr. VEDDER. Well, I would agree with you in saying that only a small part of it is in effect. Going back to your original point, Senator Symms, you were asking which of these three proposals is superior.

I would agree with Craig Roberts in saying that any one of them is a monumental step forward, even Bradley-Gephardt with a 30-percent top marginal rate. Thirty percent is better than 50 percent. However, 20 percent is better than 30 or 19 percent or whatever Hall-Rabushka is, and Hall-Rabushka has the added advantage of not requiring any worry about indexation at all. I mean, it disappears from consideration if you have a flat rate, whereas with Bradley-Gephardt you still have the potential bracket creep arising because of the fact that there is an implicit progressivity in it which lends itself to mischief later on when people want to go and add another bracket one or two or three or four.

So I would say that you should be commended for supporting the Hall-Rabushka plan because it is sort of the extreme, if you like.

Senator SYMMS. It's the touchstone.

Mr. VEDDER. It's the touchstone, the one that can't be beat in terms of going to the lowest possible flat rate with the largest base. Now there are some problems with Hall-Rabushka, but I'm just saying that if you really want to go all the way, that's the way to go.

Senator SYMMS. Well, last weekend two economists from the Brookings Institution unveiled a proposal which would tax consumption rather than income and I couldn't help notice that the tax rates they recommended are much lower than our current income tax rates. I also noticed that the Washington Post yesterday gave President Reagan the credit he deserves for playing a big role in altering the attitude of the public and policymakers toward taxation of the economic effects of taxation.

Are any of you aware of the Brookings consumption tax proposal? Is it a good one?

Mr. ROBERTS. It's certainly a better tax system than we have now. It's basically a consumption-based income tax that excludes all income saved from the tax base and it has I think a top rate of 32 percent, the same for corporations. What it does require—and these are details of the proposal—is that individuals and businesses report all borrowing as income. They can deduct all investment. For example, business would have a 1-year writeoff of all investment expenses.

I think the most serious problem with it is detail that is not an integral part of the proposal, such as to have all inheritances treated as income so if someone comes into an inheritance it is taxed as income. This treats wealth as income and wealth is a different thing than income.

I think it is not as good a system as Hall-Rabushka, for certain, but what it shows you is that even that liberal economists in the Democratic think tanks are moving in the same direction.

Senator SYMMS. That's good. That's a plus. Well, I'll just make one other comment. I've said this before. One of the disturbing things is that it seems like we don't have to go very far to find that we're our own worst enemies. When the President gave a speech in Boston a couple years ago and said that he would like to abolish the corporate income tax or his goal would be to get rid of it so that we could have honesty in the Tax Code because people pay all the taxes anyway and business just ends up being a tax collector for government, and it interferes with the process of capitalization, before he got off the podium, the apologists at the White House were telling the press that that's really not what the President meant. I think that's just tragic. If you go out to the farm cooperatives in the country in the West and places where they can actually accumulate capital and they don't have to pay taxes on it until they distribute the income, it's a much better system and we should adopt that for all corporations. What always bothers me is the business community will raise heck about the tax break given to farm co-ops because they say it's unfair competition, when what they should be doing is arguing to give all corporations those same privileges so that if they would pile money in and build plants and equipment and so forth, that they would pay no taxes on it until they distribute the income and then you'd have an honest system.

But we're our own worst enemies in this thing because everybody wants to get everybody else paying taxes and I hope that something does come of it, but my fear is that there will be a massive tax increase if we're not careful on any major reform of our Tax Code.

I appreciate all of you for your help and efforts to keep some light on this subject so that those people like Paul Volcker and others who continually threaten Congress that if we don't raise taxes, he's going to push the discount rate up, and so forth—I hope that we can in fact get this information out to the public because it's so badly needed to restore confidence in the capitalistic system and that's really what's needed, confidence in capitalism, and if we have that, our system surely will survive. We can't lose.

Unless there are any other comments that any of you want to make, the meeting is adjourned.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

○